COMMODITY INVESTMENT FRAUD

HEARINGS
BEFORE THE
PERMANENT
SUBCOMMITTEE ON INVESTIGATIONS
OF THE
COMMITTEE ON
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
NINETY-SEVENTH CONGRESS
SECOND SESSION

FEBRUARY 23, 24, AND 25, 1982

Printed for the use of the Committee on Governmental Affairs

U.S. GOVERNMENT PRINTING OFFICE
92-724 O WASHINGTON : 1982

S401-33

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COMMODITY INVESTMENT FRAUD

TUESDAY, FEBRUARY 23, 1982

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met at 10:20 a.m., pursuant to notice, in room 3302, Dirksen Senate Office Building, under authority of Senate Resolution 361, dated March 5, 1980, Hon. William V. Roth, Jr. (chairman of the subcommittee) presiding.

Members of the subcommittee present: Senator William V. Roth, Jr., Republican, Delaware; Senator Warren B. Rudman, Republican, New Hampshire; Senator Sam Nunn, Democrat, Georgia; and Senator Lawton Chiles, Democrat, Florida.

Members of the professional staff present: S. Cass Weiland, chief counsel; Tom Karol, staff counsel; Eleanore J. Hill, chief counsel to the minority; Katherine Bidden, chief clerk; and Roy Geffen, staff investigator.

[Members present at convening of hearing: Senators Roth, Rudman, and Nunn.]

Chairman ROTH. The subcommittee will be in order.

This morning the Permanent Subcommittee on Investigations undertakes several days of hearings into the continuing phenomenon of commodity-related investment fraud schemes. Let me start out by saying that, to me, what I have learned about regulating the sale of commodities is another illustration where well-intended laws are failing in its basic purpose of protecting the American public. I found the nature and extent of these types of schemes being perpetrated on the American public to be absolutely shocking.

The facts uncovered in our investigation show a continuing pattern of criminal activity which has gone on almost unfettered since the creation of the Commodity Futures Trading Commission in 1975. The evidence shows that at least $200 million a year is being soaked up, bilked by the con artist operating under the guise of legitimate commodity investment firms, and the result has been the victimization of thousands and thousands of Americans, both young and old. Tragically, too often it is older people, widows who lose their life savings because of these con artists.

Frankly, during this time, the principal enforcement agency, the CFTC, has been seriously outgunned by its opposition. The CFTC, with its roughly 25 lawyers and 10 investigators charged with protecting the public, the investing public, has been no match—no match—for the avalanche of schemes based on the numbers, if nothing else.

One of the things that concerns me the most is that Federal legislation preempted this field so that State security administrators, whose offices are charged with the responsibility of protecting citizens against investment frauds, have been forced to stand on the sidelines. They can do nothing. They say they find themselves preempted simply because the con artists classify their investment schemes as commodity related.

So this is one of the things we will be looking at, the preemptive language of the Commodity Exchange which has, as I said, sidelined State administrators.

I expect evidence to be developed this week which will show an astronomical recidivism rate among these commodity con artists. What we really have is a floating crap game. These con artists float in and out, rotating in and out of boilerrooms like clockwork, and we intend to make available to our law enforcement agencies our nationwide study of these schemes in hopes it will help them crack down on these people whose names reappear all too often.

I also point out that the law has failed in several other particulars. For example, it is so easy to register under the law that it helps the crooks, the con artists in their telephone calls to the little old lady or the widow or even the young. They often say, "Well, we are registered." The fact of the matter is registration means nothing.

The law set up reparations which, hopefully, was intended to be a relatively simple administrative basis of recovering funds for those who are conned out of their money. Instead of working well, it has been bogged down with redtape and, rather than helping, has been a hindrance.

So I think this is an opportunity for the subcommittee to continue its work in the area of law enforcement which, of course, has had a heavy emphasis on organized crime over the years. The commodity fraud problem is a subject which has received all too little attention by Congress, and I am delighted that we are holding this public hearing at the very time that the agency itself is coming up for review.

Senator Rudman.

Senator RUDMAN. I do not have an opening statement, Mr. Chairman.

Chairman ROTH. Senator Nunn.

Senator NUNN. I will put my opening statement in the record.

[The document referred to follows:]

OPENING STATEMENT OF SENATOR SAM NUNN

Senator NUNN. Mr. Chairman, I am very pleased to be here today and to participate in these hearings on commodity investment fraud schemes. This subcommitee has for years investigated many areas in which unscrupulous individuals have taken criminal advantage of an unsuspecting, unprotected public by means of fraudulent schemes. In the past we have worked to expose these schemes in order to inform the public for its own protection. We have also worked to examine how effectively our own Federal law enforcement agencies have been in coping with these criminal operators, and we have introduced legislation whenever necessary to strengthen law enforcement's posture. I am anxious to extend my full support to your continuation of these important efforts, and all of us on the minority side will continue to cooperate with you.

Commodity investment fraud schemes have become a tremendous, chronic problem since the mid-1970's. While commodity fraud itself is not new, the scope of the problem is. At the present time most such schemes involve high pressure telephone sales of gold and/or other precious metals. The targets of these schemes are too often unsuspecting, unsophisticated individuals who are trying to find a safe, legitimate investment for their life savings. Too late they discover that they have paid out large amounts of cash for metals never purchased, or for exorbitant management fees. Too often they find that they have no real recourse in recovering their hard-earned money.

Commodity fraud has been a concern of Congress for many years. In 1974 Congress established the Commodity Futures Trading Commission and charged it to regulate and police this field. In 1978 Congress amended the Commodity Exchange Act, and reauthorized the Commission to continue its work for 4 years. This year we must again consider whether to reauthorize the Commission. This means we should consider here the scope of the fraud problem as well as the Federal and State response to that problem. By close examination in this hearing we can better inform the public and assist ourselves as Congressmen in our deliberations on the reauthorization of the Commission.

These hearings are most timely, Mr. Chairman, and I congratulate you and the staff of this subcommittee for your work on an issue of pressing importance.

I congratulate the chairman and the staff of the subcommittee for bringing up a very serious problem in a very timely fashion. With the legislation we are going to be considering this year in this area, I think the investigations that have already taken place and the hearings, which will demonstrate some of the more vivid examples of fraud in the commodity field, will be a great help in framing the legislative response.

There is nothing new about commodity fraud. We have had it for a long time, but the scope of the problem is much different today than it was in the past. And that scope is a very broad scope that threatens many people and, of course, the commodity business itself is growing very rapidly.

So I think the hearings are timely, and I look forward to hearing the witnesses.

Chairman ROTH. Thank you, Senator Nunn. Our first witnesses today are all victims of various commodity schemes. We have with us George Connor of Quakerstown, Pa. If you would please come forward and sit down at the table as your name is called. Barbara Hess from Blairstown, N.J.; Dave Schonbach from Wilmington, Del.; and Pauline Hazebrouck from Woonsocket, R.I.

Will you all please rise so that—as well as Roy Geffen, our staff investigator—so you may be sworn in at this time. Raise your right hand.

Do you solemnly swear that the testimony you are about to give before this subcommittee is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. Connor. I do.

Ms. Hess. I do.

Mr. Schonbach. I do.

Ms. Hazebrouck. I do.

Mr. Geffen. I do.

Chairman Roth. I would tell the group that it is a rule of this subcommittee that all witnesses are sworn. I understand you all have short statements for the record, so let's begin with Mr. Connor, and we will proceed through the rest of the panel. Mr. Connor.

TESTIMONY OF GEORGE CONNOR, BARBARA HESS, DAVE SCHONBACH, PAULINE HAZEBROUCK, AND ROY GEFFEN, STAFF INVESTIGATOR

Mr. Connor. My name is George Connor. I am 70 years old and live with my wife, Marian, in a mobile home park in Quakertown, Pa., approximately 40 miles north of Philadelphia. I am retired from my job with a manufacturing/engineering company in Philadelphia.

In the early part of 1979, I answered an ad in a magazine as I was interested in getting involved in gold because I had heard on television and in various magazines how it would be a good hedge against inflation. I was contacted by a couple of companies, but the second salesman was much more high pressure, and I fell for his pitch. The salesman represented a firm called Consolidated Gold & Silver in Miami, Fla. The initial investment was for a gold deferred payment plan which was for one contract of 10 ounces of gold for the price of $3,000. The price was supposed to represent 10 percent of the market value for the gold. The contract was due in 6 months. I knew at that time I would have to close out the contracts and pay the full price. In addition to controlling the 10 ounces of gold, I also received in the mail five kruggerands.

During the period of March 1979 and June 15, 1979, the salesman convinced me to buy additional gold contracts on eight different occasions. I paid either $4,000 for a contract and received five kruggerands, or I paid $3,000 for the contract and received no kruggerands. During that 90-day period, I bought a total of 11 contracts for 10 ounces each and invested a total of $40,000. I also received 35 kruggerands in the deal.

Of course, during that time, the salesman was very interested and kept me on the ball by calling at least twice a week, sometimes oftener, to let me know how much the gold was going up or how much money I was making and to convince me to buy more gold. But as the contracts became due, I stopped hearing from him. I tried to cash in the first three contracts in October, but was told I was too late for each.

The contracts did specifically state if I did not meet the deadline, I would forfeit the contract. The salesman, although somewhat apologetic, convinced me that I had nothing to worry about as I still had eight contracts and I had plenty of chance to make a lot of money.

He told me to send in the balance money for the next two contracts as gold was up to $700 an ounce, up from $254. On October 9, I sent in a check of $25,000 to cash in one of the contracts, for him to buy the contract. I sent an additional check for another contract of $25,700 to close out those two contracts. After sending off the checks totaling $50,940, I never heard from the company again, except in November when I was told that the next contract's dates were changed from November 1979 to February 1, 1980, an obvious stalling technique.

In all, I invested a total of $90,940, but did manage to sell my 35 kruggerands for about $13,000. My total cash loss to Consolidated Gold was $77,690.

The salesman had convinced me each time that I could not lose money, and I could tell by following the papers myself how much the gold was increasing in value. I figured the profit from my first contracts would allow me to pay in full for each contract when they became due. I had no reason to doubt the company at first as they even furnished the kruggerands to prove that they did deal in gold. That is about how I came out.

Chairman Roth. I think what we will do is get the testimony from each one of you, Mr. Connor, then we will ask questions afterward. Thank you. Next, Barbara Hess.

Ms. Hess. My name is Barbara Hess. I am 51 years old, unmarried, and live with my 83-year-old mother. Neither my mother nor I work, and we survive solely on social security income.

I feel I must explain, then, how I had the money to get involved in the investments which ultimately took every penny my mother and I had in the world. We owned a home in northern New Jersey and had decided to sell it and move to the country for a quieter and cheaper lifestyle. We sold the house, with the intention of buying a new one, but the market and interest rates were so bad that we decided to rent for a while. I wanted to put all of the money from the house into a safe investment which would be very liquid in case we wanted to buy. All the money I invested was the house money.

I was studying up on investments, and through discussions with friends, I realized precious metals were going to move. I knew a little about leveraging, and I was looking for a company I could deal with. I eventually responded to an ad in June 1979, in the Wall Street Journal, for a company called Federal Gold and Silver in Minneapolis. They sent me a brochure in the mail and, then, a few days later I received a call from a salesman. The salesman was very professional and answered all my questions concerning the company. He assured me that I could withdraw my funds at any time. I had told the salesman that I only had this house money to invest and he assured me that there was no risky futures or options or any problem with the investment. After checking first with the CFTC and Better Business Bureau, I opened up an account to buy gold, using leverage.

On August 8, 1979, I purchased 160 kruggerands valued at $300 per ounce and worth a total of $48,000. I paid $10,808. On the next day, I purchased another 160 coins for $10,198. Between August 9 and August 27, the salesman kept calling me and telling me what good investments I made and how gold was going to continue to go up.

On August 27, he induced me to withdraw the balance of my savings, which was approximately $9,500, which I had placed in a money-market fund. He then convinced me to purchase 80 additional coins for which I paid $5,460. I simply endorsed the check from the money-market fund and sent it to Federal Gold and Silver. They said the balance of the check, approximately $4,000, was credited to my account for additional purchases.

On the next day, I purchased 160 more coins for the purchase price of $20,448. I paid for these with the balance of the money-market fund already credited to my account, plus a check for $3,035, and I mailed Federal Gold and Silver 42 kruggerands which I had purchased just prior to getting involved with that company.

On or about September 4, 1979, I started getting very nervous and anxious about the investments, so I decided to sell. I called the salesman and requested all my investment and profits to be withdrawn and sent to me except for about $4,000. The salesman had me speak to one of the officers of the company who managed to convince me through his smooth talking to leave the money in. He reassured me that I had complete control of the money and could take it out any time I wanted to.

About a week later, I called to definitely withdraw all my money, but the line was busy all day. The next day I finally got through. I was told by an attorney that the Federal Government had temporarily halted all business of Federal Gold and Silver and it could do nothing for about a week.

I never heard from the firm again. I also learned that the State of Minnesota came in and audited Federal Gold and Silver in April 1979 and apparently blew the whistle, but the firm was still allowed to operate and take my money as late as August 28, 1979.

Chairman ROTH. Thank you, Ms. Hess. Next I would like to welcome Dave Schonbach who is from my hometown of Wilmington. Dave, will you please proceed?

Mr. SCHONBACH. My name is Dave Schonbach. I am 34 years old, married, and have a Ph. D. in electrical engineering. I am a computer consultant with the Engineering Department of the E. I. du Pont Co.

Back in early 1979, I received a packet of business reply cards unsolicited in the mail. I had mailed a couple of them back because I was somewhat interested in trying different investments. I later received a telephone call from a salesman representing one of these firms called Connors and Davenport. The salesman told me they were registered with the CFTC. I called the CFTC hotline number and left my name and number, but they never returned my call.

I already had one gold contract on margin with another firm and was looking for a different vehicle. Connors and Davenport described a deferred delivery contract to me, which seemed to meet my goal.

The salesman initially wanted me to invest in a 5,000-ounce silver contract. Finally, we settled on a 4,500-ounce contract with a total price of $7,415 which included a 5-percent commission of $370.

The contract for silver was for 6 months, and the silver was valued at $8.85 an ounce. I was a little concerned about how the finances flowed, so I asked them specifically, "If I sold tomorrow, what would I get back?" The salesman said that I would get back the $7,415 minus the $370 commission.

It turns out that this was not explained to me properly. They never told me I would never see the $7,415 again, nor did they make it clear that if the price of silver went below $8.85, I would get nothing. It turned out the entire $7,415 was their non-refundable fee.

I never received a copy of the contract, only a confirmation paper. After sending them my money, the firm never returned my calls or answered the mail, nor did they sell the contract as requested. I never saw any of the $7,415 again.

I contacted the CFTC hotline number on two occasions and left a message to have them return my call. Neither call was ever returned. I eventually contacted the Washington office directly and was told that the firm was being investigated. I asked them what I could do, and they sent me a reparations claim form. I sent the form in and received acknowledgement of receipt from the CFTC. I never paid the $25 filing fee because the CFTC would not accept my complaint. I was also contacted by the Postal Inspectors in Phoenix who asked me to fill out a questionnaire.

As a result of this bad experience, I have completely altered my investment strategy to a conservative approach. This has significantly reduced my return on investments.

Chairman Roth. Thank you, Mr. Schonbach. And last we have Pauline Hazebrouck.

Ms. Hazebrouck. My name is Pauline Hazebrouck. I am 67 years old. I am widowed and I have three grown children. I am employed as a typist for the Rhode Island Welfare Department in Woonsocket, R.I.

In the winter of 1980, I answered an ad in a magazine relating to investing in commodities. I was interested in seeing how people made money, so I sent in the card. I made a telephone call to International Precious Metals Corp. and spoke to a salesman. He convinced me to buy a leverage contract for $5,000. He spent some time explaining what a leverage contract was, and I finally agreed to the sale. I paid an additional $5,000 for margin calls. Eventually, I got a check back for $2,600, but the salesman called me back trying to resell me. I remember him using the line, "Just because you've had a car accident doesn't mean you don't drive anymore." I did not buy any more contracts from him.

In December 1980, I received a phone call from another salesman representing the firm First Commodity Corp. of Boston. It took a couple of calls to convince me to invest. I finally bought a $4,000 futures contract in gold, and I was also put into other commodities like wheat and copper. I eventually lost $3,800 of my $5,800 investment with them.

While I was still involved in the copper, I received a call from a salesman who represented Prime Precious Metals Co. He called many times and kept explaining to me how I was not making money with First Commodities of Boston. He promised to make money for me, so I bought two 500,000 Mexican pesos contracts for

$2,988 each. He told me I could make a lot of money and convinced me that I should get out of the copper contract with FCCB.

After my initial investment with Prime Precious Metals, I stopped hearing from that salesman and began hearing from another salesman named Toni Hunt. Mr. Hunt represented Premier Precious Metals Co. which took over for Prime Precious Metals. He proceeded to smooth talk me into purchasing four different contracts for silver and copper.

During the 1-month period where I bought the four contracts from Premier Precious Metals, Toni Hunt convinced me to borrow from my certificates of deposit and even from my sister.

During the next 2 months, Mr. Hunt kept changing firm names, but continued to sell me various strategic metals. He sold me two contracts in manganese and cobalt while working for Prime Strategic Metals, and he sold me cobalt and germanium while employed with Prime Strategic Metals Internationale. On one occasion, I changed my mind about buying a contract, and Mr. Hunt told me I had no choice. He said I had to pay or I was in default. I had asked him what that meant, and he said he was telling me in a nice way that I had to pay. I also bought my last contract from Toni Hunt which was for manganese, and he was operating SMI Funding Corp. In total, I made 13 separate investments with these firms totaling $88,122. I have never seen any of the money from the investments beginning with the Mexican pesos.

All of these contracts were for 12- to 15-month delivery dates and, up until this point, only one contract is about due. This contract was the first for Mexican pesos and was scheduled for settlement on February 22, 1982, which was yesterday. I received a letter in the mail dated January 24, 1982. That letter suddenly asked me for delivery instructions and that I would be charged interest of 10 percent on any unpaid purchase price. The letter was signed by Mr. Terry Ziegler who was named as the president on the letterhead of Prime Strategic Metals Co. I ignored the letter as I found out in September or October of 1981 that Toni Hunt had disappeared, and then I began to investigate the firm.

I contacted the CFTC in Washington and was told that the firms were under investigation. I realized then that I had lost all my money.

Chairman Roth. Thank you. I, first of all, want to express the appreciation of the subcommittee to each one of you for appearing before our panel. I fully appreciate and understand it is not very easy to come forward and discuss these problems which occur all too often. But I think what you are doing here can be very helpful, very helpful from the standpoint of giving us a better insight as to why the law, why the Commission is not able to do an adequate job.

Perhaps even more importantly, I would hope that the coverage, the publicity given your cases will be helpful to the public at large because it does seem to me one of the most important things is to make the public generally aware that there are con artists around who are going to try to bilk them of their funds.

So I just want to express to each one of you my great appreciation.

I would like to ask one question of each of you—the same question—and that is, what contact did you have with Commodity Futures Trading Commission? Of course, if you have had none, then that will end the question, but if you did have contact, the nature of it, even though you may have spelled it out some in your testimony, whether you felt they were helpful, what you think needs to be done to correct the weaknesses of the law. Mr. Connor, would you care to comment?

[At this point, Senator Rudman withdrew from the hearing room.]

Mr. CONNOR. I never contacted them in advance. I talked about them later when I got to the postal inspector and U.S. attorney's office when they were prosecuting, but I had not contacted them prior to that time.

Chairman ROTH. So you have had very little communication. Dave, would you care to comment?

[At this point, Senator Rudman entered the hearing room.]

Mr. SCHONBACH. Before making my investment with Connors & Davenport——

Chairman ROTH. Would you bring the microphone a little closer?

Mr. SCHONBACH [continuing]. I called the CFTC 800 number which had turned out to be an answering service, and I left my name and telephone number. They never returned my call. Later when I was having problems contacting Connors & Davenport directly, I attempted to call them again on that number and left my name and phone number, and they didn't return the call.

Later, I obtained their Washington number and called them directly. At that time, they told me that Connors & Davenport was under investigation. So I asked them what I could do, and they sent me a form to fill out to file a claim with them.

Somewhat later, I was concerned what was happening so I sent them a letter asking what had happened. I believe it would be appropriate if I could read two excerpts from letters I did receive from them.

The first letter is dated November 30, 1979, and this is in response or acknowledging receipt of the complaint that I did issue against Connors & Davenport. This is paragraph 2 in that letter:

> Connors & Davenport, Ltd., is not registered with the Commission as required by law and appears to no longer be in business. Our attempt to serve complaints upon the firm at their principal place of business, Greater Arizona Savings Building, Suite 412, Phoenix, Arizona, 85004, have been unsuccessful. Until an address is obtained, we will not attempt to serve your complaint on Connors & Davenport, Ltd.

Several months later, I sent a letter to the CFTC to determine the status of that complaint. In reply, I got a very short two-paragraph letter dated March 10, 1980:

> In answer to your letter of February 11, 1980, Connors & Davenport is no longer in business, and we are unable to serve your complaint at the address given in the complaint. Unless you provide this unit within 30 days with an address at which Connors & Davenport can be successfully served, we will take no further action on this matter and the file will be closed.

My interpretation of that letter is that if I wanted anything to be done, I should conduct my own investigation and, when completed, give the results to the CFTC, all within 30 days. There is just no way that I have the resources to conduct such an investigation.

Chairman Roth. I find that unbelievable. Here is a procedure, reparations, that was theoretically established to help people out that were in your plight. So instead of helping you, it seems to me they were just doing the very opposite. It is obvious the system is not going to work if that is the approach.

Mr. Schonbach. I agree.

Chairman Roth. I would like to ask that we have copies of those letters to be included as part of the record.

[The documents referred to were marked "Exhibit No. 1," for reference and may be found in the files of this subcommittee.]

Chairman Roth. Let me go on now. Ms. Hess, your comments.

Ms. Hess. I had contact with the CFTC in the beginning before I invested anything. I set out to, a term I have used right along, research the various companies, and I contacted the Chicago CFTC by phone. I was told to call the New York City office. When I did this, I was referred to their 800 number. There was a woman—she had a very young voice. She identified herself as Jackie on that 800 line, and I found out later that she was the only individual who manned that line at any time. She had full charge of it. When I asked specifically about Federal Gold and Silver, I was told that they, indeed, were registered with CFTC and that the firm was in good standing with them. And that statement from the CFTC representative was really the spur that gave me the confidence to deal with Federal Gold & Silver. I thought it was a legitimate firm. I was totally naive assuming that coming from a government agency, that it meant something.

The Federal Gold and Silver stationery and also the salesman practically flaunted this "registered with the CFTC" phrase. When the receivership took place, I immediately did what I could to contact the CFTC. The 800-number—Jackie vanished. I couldn't get her on the phone and, in fact, the 800 number rang on and on. It didn't answer for days.

The reparations form, which was sent to me, obviously needed an attorney, but I did file through a commodities attorney in August of 1981—I filed within their 2-year statute of limitations, and it was very complicated. My attorney told me, in answer to a remark I made, that indeed, in his opinion, it did take a commodity specialist to find his way through this form which was supposed to be for the layman. And I would like Mr. Geffen to continue here with some of the difficulties that my attorney has had both with the CFTC and the receiver in Minnesota who is handling Federal Gold and Silver.

Chairman Roth. Mr. Geffen.

Mr. Geffen. Briefly, Mr. Chairman, I had an opportunity to talk to Ms. Hess' attorney, Wayne Greenstone of Newark, N.J. He sent in that reparations claim form in August 24, 1981. The complaint was returned by the CFTC on October 20 of 1981, and the reason given was that there were not enough specifics concerning the respondents in her case.

A few day later, he called the CFTC and they said, and I don't know who "they" is, they were going to check with the legal people at the CFTC and they would get back to him and see if they could extend the 15-day time limit. He then sent letters to the CFTC on

November 30, January 7, 1982, and February 8, 1982, and he still has heard nothing from them.

Chairman ROTH. I feel like I ought to ask Ms. Hess which was more frustrating, dealing with the one selling the futures or the Federal agency?

Ms. HESS. Well, of course, I was buffered by my attorney, but——

Chairman ROTH. The whole experience was outrageous.

Ms. HESS. Terrible; terrible.

Chairman ROTH. Go ahead, Mr. Geffen.

Mr. GEFFEN. That's all.

Chairman ROTH. I find what you have to say, Ms. Hess, again, unbelievable. No. 1, your statement that when you called initially they told you that this firm was registered and in good standing demonstrates the point I made earlier that the registration which was supposed to help the public, because of the simplistic approach apparently being taken, is self-defeating instead. It is misleading the very people you are trying to help.

I assure you, when the head of the agency comes up in a couple of days, we will ask him questions about that specific case.

I am also concerned by the fact here was a procedure where you were not supposed to need any lawyer at all, and it became so bogged down in legal niceties that it collapsed of its own weight. I thank you, Ms. Hess.

Now I would like to ask Ms. Hazebrouck for your comments.

Ms. HAZEBROUCK. I filed a claim with CFTC just this past month, and nothing has been done yet.

Chairman ROTH. No action.

Ms. HAZEBROUCK. No.

Chairman ROTH. You are just starting. I want to turn it over to the other Senators, but I find this raises some very serious questions as to the effectiveness of the agency itself. Senator Rudman.

Senator RUDMAN. I wonder if any of you could tell me if you had contacted any authorities at the State level other than what you did in terms of contacting the CFTC? I wonder if we could start with Ms. Hess. Did you contact anyone else?

Ms. HESS. I made—I don't want to make a false statement here. I have a very flat file at home which covers this couple of years period. I specifically tried to find out about this audit. This was recently, within the last few months, and I didn't get anywhere. I felt perhaps while there is always this in back of my mind, that is, there is a suit, possible, against some agency here—what I am interested in is recovery of some money for sheer survival financially, but I didn't get anything viable back from them.

Chairman ROTH. Mr. Schonbach.

Mr. SCHONBACH. I did not contact any State official. Primarily I was given the impression by others in the investment field that it was not under the State jurisdiction, and I would have to go through the CFTC. I was at one time considering sending a letter to Senator Roth and my other Senator to see what could be done, but dismissed that also.

Senator RUDMAN. I assume if you had bought an automobile for $10,000 and went to get delivery of the automobile and the dealer refused to deliver to you that you would probably go to some State or local law enforcement authority to try to get help to get delivery of that car. That is a reasonable thing to do.

Mr. **Schonbach**. Yes.

Senator **Rudman**. But this being commodities, you just assumed, and I think correctly, that the Federal Government had essentially preempted the States.

Mr. **Schonbach**. There was another agency that was investigating this also, and that was the postal inspector in Phoenix. So far as I was concerned—I was reviewing this in my home, looking through the papers I did have, there were two Federal agencies working on this.

Senator **Rudman**. And that gave you, at least initially, some comfort?

Mr. **Schonbach**. Yes, at least that something would be done. I was not confident that I would ever see the money again, but at least I was hoping that by giving my testimony and filing these complaints that perhaps I could do something to prevent this sort of thing happening to other victims.

Mr. **Connor**. I had originally contacted not a State organization but the Better Business Bureau because I was starting to get nervous the way things were going. I didn't get any answer at all, and I thought everything was OK. Finally, I called the Better Business Bureau in Miami, Fla., and they said that they have been trying to get some information on him, on this company, but they had turned it over to the postal inspector.

They gave me the postal inspector's phone number and name. I called them. They knew all about it, and they referred me to the U.S. attorney's office. Then I finally found out what was going on.

Senator **Rudman**. Ms. Hazebrouck.

Ms. **Hazebrouck**. No, I did not contact anybody else but CFTC.

Senator **Rudman**. I understand you work for the State of Rhode Island.

Ms. **Hazebrouck**. Yes, I do.

Senator **Rudman**. It never occurred to you to contact any State agencies such as the State attorney's office?

Ms. **Hazebrouck**. At one time, I was thinking of giving contact to the attorney general in Fort Lauderdale.

Senator **Rudman**. Mr. Chairman, the reason, of course, I ask the question is because I think the very thrust of these hearings will be directed to whether or not this kind of fraud is really different from most kinds of fraud and, in many cases, cannot be handled in a far more efficient manner at the State and local level. Certainly, it isn't being handled very well at the Federal level.

I don't have any other questions of these witnesses other than to—do you have a comment?

Ms. **Hess**. I did fail to say one thing. I wrote to my Congressman on several occasions, and it was about mid-1981, my second correspondence with him, and he suggested I write to the attorney general's office in Minnesota, which I did. It was just thrown right back in my lap with letters that the matter was not within their jurisdiction. I thought this was rather stupid because my Congressman—that was his one suggestion, and it just was invalid.

Senator **Rudman**. I just want to say to the witnesses, Mr. Chairman, that I join you in thanking them for their testimony. They obviously are just a very, very small tip of the iceberg that exists in this country of tens, and maybe hundreds, of thousands of people who have lost not millions, but hundreds of millions of dollars because, in my view, a law that had reasonable intentions at the outset has failed miserably. I certainly hope the result of these hearings will be to recommend legislation that will correct that.

Chairman ROTH. Thank you very much, Senator Rudman. I, as you know, share your concern as to what has happened at the State level.

I regret that Senator Nunn had to be called out for another meeting. We will leave the record open so that in the event he or any other member of the panel have additional questions, they would submit them in writing. I would ask that you respond.

I want to express the appreciation of the subcommittee for your extraordinarily helpful testimony today. Thank you very much. You are now excused.

At this time, I will call on Mr. Weiland to introduce a number of exhibits on behalf of the subcommittee.

Mr. WEILAND. Mr. Chairman, because of our limited time, I think it is appropriate that the staff's written statement summing up our investigation simply be offered into the record. It summarizes the indepth work performed by our investigators over the past 8 months. I do expect staff to testify tomorrow about some aspects of this statement, but I would offer it in its entirety at this time.

Chairman ROTH. Without objection, so ordered.[1]

[The document referred to was marked "Exhibit No. 2," for reference, and may be found in the appendix on p. 145.]

Mr. WEILAND. I would like to enter several exhibits, including several charts we have prepared. The first is captioned "The Commodity Club," and it requires a little bit of an explanation.

[The chart referred to was marked "Exhibit No. 3," for reference and follows:]

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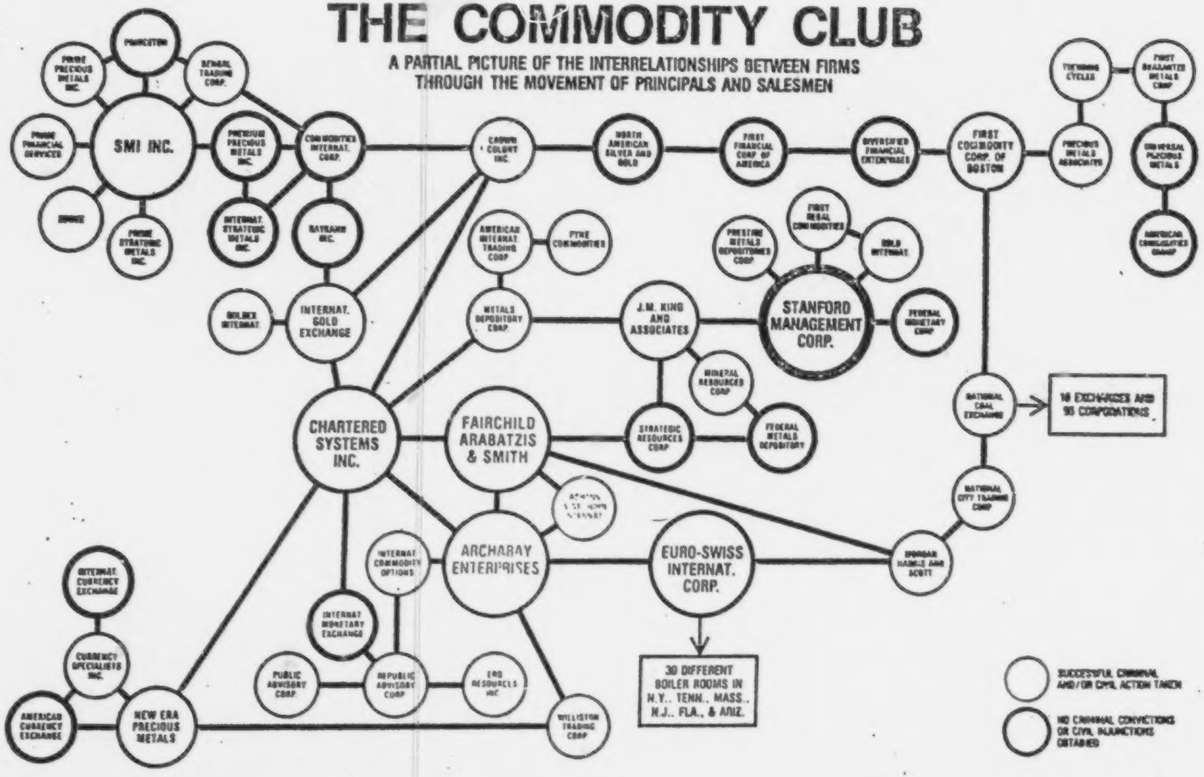
[1] See p. 145 for the staff's prepared statement.

EXHIBIT NO. 3

THE COMMODITY CLUB

A PARTIAL PICTURE OF THE INTERRELATIONSHIPS BETWEEN FIRMS THROUGH THE MOVEMENT OF PRINCIPALS AND SALESMEN


PRINCETON
PRIME PRECIOUS METALS INC.
BENGAL TRADING CORP.
PRIME FINANCIAL SERVICES
SMI INC.
PRIME STRATEGIC METALS INC.
PREMIUM PRECIOUS METALS INC.
INTERNAT. STRATEGIC METALS INC.
COMMODITIES INTERNAT. CORP.
GOLDEX INTERNAT.
INTERNAT. GOLD EXCHANGE
CROWN COLONY INC.
NORTH AMERICAN SILVER AND GOLD
FIRST FINANCIAL CORP OF AMERICA
DIVERSIFIED FINANCIAL ENTERPRISES
FIRST COMMODITY CORP. OF BOSTON
PRECIOUS METALS ASSOCIATES
FIRST GUARANTEE METALS CORP
UNIVERSAL PRECIOUS METALS
AMERICAN COMMODITIES GROUP
AMERICAN INTERNAT TRADING CORP
PYNE COMMODITIES
METALS DEPOSITORY CORP
J.M. KING AND ASSOCIATES
PRESTIGE METALS DEPOSITORIES CORP
FIRST REGAL COMMODITIES
GOLD INTERNAT.
STANFORD MANAGEMENT CORP.
FEDERAL MONETARY CORP
MINERAL RESOURCES CORP
STRATEGIC RESOURCES CORP
FEDERAL METALS DEPOSITORY
NATIONAL COAL EXCHANGE
18 EXCHANGES AND 95 CORPORATIONS
NATIONAL CITY TRADING CORP
CHARTERED SYSTEMS INC.
FAIRCHILD ARABATZIS & SMITH
ARCHARAY ENTERPRISES
EURO-SWISS INTERNAT. CORP.
30 DIFFERENT BOILER ROOMS IN N.Y., TENN., MASS., N.J., FLA., & ARIZ.
INTERNAT COMMODITY OPTIONS
INTERNAT MONETARY EXCHANGE
PUBLIC ADVISORY CORP
REPUBLIC ADVISORY CORP
ERG RESOURCES INC
WILLISTON TRADING CORP
INTERNAT. CURRENCY EXCHANGE
CURRENCY SPECIALISTS INC.
AMERICAN CURRENCY EXCHANGE
NEW ERA PRECIOUS METALS
SUCCESSFUL CRIMINAL AND/OR CIVIL ACTION TAKEN
NO CRIMINAL CONVICTIONS OR CIVIL INJUNCTIONS OBTAINED

Mr. **Weiland.** Essentially, the chart provides a limited picture of a common feature in the commodity scam business; that is, people involved tend to move from one firm to another. There is no beginning or end to this chart. You can simply pick it up at any particular point and follow the progress of principals or salesmen of the firms represented on the chart from one firm to another.

I would point out that the staff had to cut the chart off at some point. I think we have approximately 50 firms represented. We could have gone on and on to list approximately 200 more firms.

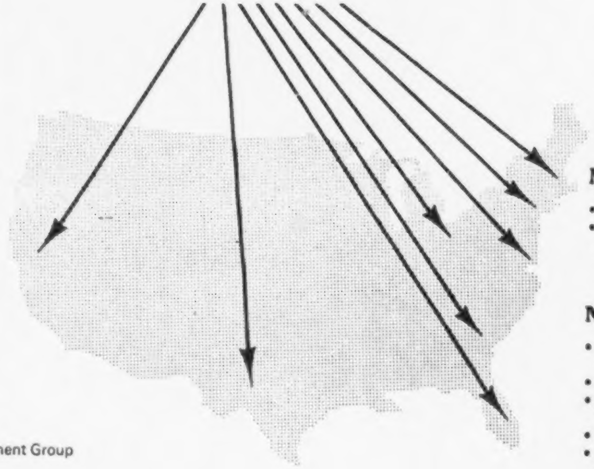
The second chart deals with a commodity case we will be hearing about today and a little tomorrow. It is entitled "Comercial Petrolera Internacional." It is also called the Bartex case or crude oil case. It shows a nationwide network of retailers who were set up to handle the marketing of crude oil contracts in 1979 and early 1980. Several of our witnesses today had some association with this case.

[The chart referred to was marked "Exhibit No. 4," for reference, and follows:]

EXHIBIT NO.4

Principal • **COMERCIAL PETROLERA INTERNACIONAL** • Panama
Agent • **INTERNATIONAL PETROLEUM EXCHANGE** • New York
Wholesaler • **BARTEX PETROLEUM CORPORATION** • New York

RETAILERS



CALIFORNIA

- West American Oil Company
- IDE International
- PEMCO Petroleum, Inc.
- Petron Co.
- Diversified Oil Investment Inc.

TEXAS

- Fidelity First Development Corp.
- First Financial Investment Group
- OPEC American Petroleum

FLORIDA

- OPEC American Petroleum

GEORGIA

- Transcontinental Petroleum Corp.

OHIO

- Summit Trading Systems
- American Commodities Trading Systems

NEW JERSEY

- First Eastern Corp.
- Universal Petroleum
- Domestic Oil Corporation

MASSACHUSETTS

- Ramco Petroleum Inc.
- American Petroleum & Oil Exchange

NEW YORK

- Mid-Atlantic Oil Exchange
- Petro International
- E&P North American Trading Corp.
- IPEC Equities Corp.
- Panamco Petroleum Enterprises
- United Petroleum Exchange Corporation
- Karet International
- Pan Eastern Petroleum Exchange
- Willard, Rooney and Williams
- Worldwide Petroleum
- North American Petro. Corp.

Mr. **Weiland**. Finally, I would like to introduce a 5-minute tape recording which was made by a boilerroom operator in New York City. Essentially, it is a conversation between a salesman named Michael Gharbi, who represented National City Trading Corp. and one of his victims, a Ms. Lillian Wooten. Ms. Wooten invested $2,500 of her own money. It was all she could, and she bought what was described to her as a deferred delivery contract for silver.

[The tape recording referred to was marked "Exhibit No. 5" for reference and remains in the files of the subcommittee.]

Mr. **Weiland**. As her contract became due, she received a mailgram from the firm stating she had to pay the full purchase price of the silver, an additional $16,900. That was not her understanding at all from her salesman, who she identifies on the tape as Mr. Kelleher. Mr. Gharbi is trying to convince her to send in the $16,900 or she will lose all of her prior investment, not to mention the profit she should be entitled to at this point.

If Mr. Gharbi was successful in getting the extra money from his victims, which he was not in this case, his next step in this scam would be to tell the customer that the supplier, Euro-Swiss, had defaulted and there was nothing the customer could do but sue Euro-Swiss. This particular firm and its three principal operators, including Mr. Gharbi, were indicted and convicted of mail fraud. Gharbi received a 1-year prison sentence and the other defendants received 2½-year and 6-month terms.

National City Trading Corp.'s boilerroom induced 140 victims to invest approximately $600,000. The people lost a potential profit in excess of $2.5 million.

Finally, I point out that the tape has been edited slightly from about an 8-minute conversation to an approximately 5-minute conversation. So there are occasional clicking noises.

[At this point, the tape recording of a conversation between Mr. Michael Gharbi and Ms. Lillian Wooten was played.]

Chairman **Roth**. Our next witnesses are Kenneth Levin and Richard Waggoner. Mr. Levin is just completing his Federal sentence for a commodity scheme centered in New York. Mr. Waggoner is still serving concurrent Federal/State sentences for his participation in the New York scheme with Mr. Levin, as well as a California operation. Please raise your right hand.

Do you solemnly swear that the testimony you are about to give before the subcommittee is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Levin**. I do.

Mr. **Waggoner**. I do.

Chairman **Roth**. Please be seated. Mr. Levin, I ask you now to read your statement.

TESTIMONY OF KENNETH LEVIN AND RICHARD WAGGONER, COMMODITY FRAUD DEFENDANTS

Mr. **Waggoner**. My name is Richard Waggoner. I am presently serving a 3-year sentence in a Federal penitentiary——

Chairman **Roth**. Just a minute, please. We would like to start with you, Mr. Levin, and then you, Mr. Waggoner. You can summarize, if you will.

Mr. Levin. I have prepared a statement and would like to enter it into the record, with your permission.[1]

Chairman Roth. Without objection.

Mr. Levin. I would like to summarize somewhat before answering any questions the subcommitte may have.

My name is Kenneth Levin. I am currently completing a 1-year prison term which I am serving for my part in a commodity fraud scheme. I pled guilty to one count of mail fraud, wire fraud, and conspiracy as a result of the charges brought against me in Boston.

Since February 1977, I have been involved with numerous commodity sales opeations. I started with a firm called British American Commodities earning a commission of 10 percent. In August 1977, I further moved to a new company, J. M. King & Associates, that was not in commodity options but managed accounts, where I felt I could earn more funds.

In 1978, I started my own firm called Meridian Equities with three other investors. I left shortly after I started that firm and became a salesman for Fairchild, Arabatzis & Smith in New York City, where I earned a commission of 20 percent. British American, J. M. King, and Fairchild were all sued by the Commodity Futures Trading Commission, and two criminal actions arose out of Fairchild, but none I was involved in.

I understand that the day the Commodity Futures Trading Commission closed British American's successor, First Regal Commodities, the principals reportedly stole $397,000 of segregated customer funds and yet were never prosecuted.

In August 1979, I formed Bartex Petroleum with Mr. James Morse. Mr. Morse and I were eventually convicted for our participation in Bartex Petroleum. We first became interested in this crude oil futures deal through a third person who presented us with a brochure. We made significant revisions in this brochure upon advice of our attorney in order to give potential customers more safety in their investment in this operation.

Based on the revised brochure, a Dun & Bradstreet statement that was given to us, references from a prominent Panamanian bank and statements made by this third party, we decided to form Bartex Petroleum to market the crude oil contracts.

We had researched the firm initially to be convinced that it was a legitimate operation. It was not until November 1979, 3 months after we went into operation, that we learned that the operation was a sham. By then, real volume was beginning to get underway, and so we continued to operate until we were closed down by New York State with a cease and desist order in December 1979.

Now, Senators, I would like to give you an idea of how boilerrooms operate. Boilerrooms are quite common in the country. There are many reasons for the numbers, none the least of which include the ease they can be set up. Likewise, as a general rule, enforcement is spotty and penalties are rarely harsh. I could start up a boilerroom operation with a minimum investment of $10,000. The only real expenses are telephones, desks, and rent deposits, file cabinets, and so forth, to fill an office. If I really worked at it, I could probably earn $100,000 per week in a high ticket operation that sells a commodity from $4 to $10,000.

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[1] See p. 184 for the prepared statement of Kenneth Levin.

If I went into a tax shelter program and a 15-man operation, I could gross up to $40 million a year. My earnings during 1979 during this operation at Bartex was approximately $120,000.

As an indication of how easy it is to set up a boilerroom, I know of one person who set it up over the telephone while he was incarcerated in prison. Boilerrooms generally consist of an owner, an office manager, and a salesman. The rooms with which I am familiar with were generally very small, very overcrowded where the salesmen were sitting on top of each other. This not only saves rent, but helps build a high level of confidence among the salesmen themselves. When a sale is closed, the other salesmen on top of him get excited from that and, of course, get on the telephone to try and generate more income for themselves. So the excitement of being in a close room is more conducive for sales. Pills and alcohol are very common in these boilerroom operations.

In my experience, most salesmen do not know whether or not the commodities they are selling are backed, nor do they ask, nor do they care. Few, if any, salesmen ever get prosecuted and, as a group, they are not worried about law enforcement efforts and much less the Commodity Futures Trading Commission.

The keystone to the industry, of course, is high, extremely high sales pressure. A device used by salesmen to make money through the sales is their customer lists. In 1979, most salesmen got names of prospective customers by buying a Dun & Bradstreet list, a Dunhill list, and many other lists circulating around the country. Not many customer lists are sold by the salesmen themselves.

People who reply to business cards sent out and people who have lost money in previous commodity deals are excellent prospects for futures sales. Selling names could be profitable. I personally sold 3,000 names at $10 each prior to being incarcerated.

Now I will go into a little bit of managed accounts and commodity trading advisers, which is a separate section of the commodity area in which these boilerrooms operate.

Managed accounts, unlike boilerrooms, generally deal in legitimate commodities trading, but that does not prevent the business from being extremely lucrative. A client will pay an upfront fee of a fixed amount to a commodity trading adviser. For illustration, I will use $5,000. Five thousand dollars is invested into a specific commodity for 1 year, of which $2,000 becomes what they call a front-load factor. The house keeps that as their commission. Three thousand dollars is used to maintain that contract on the exchange in which the customer during that year in that one specific commodity will get 10 to 20 buy and sells with no additional commission charges.

Well, what happens after that, within a week or two, the salesman calls up the customer and I will give your a brief synopsis:

> Mr. Jones, we put you in corn, but you missed the boat. You should have been in oil. Let me put you into a managed accounts program. All we do is send you new forms. Sign them for me. Since I have taken $2,000 of your money, of the five, I don't want to charge you again. I want to earn my fee. All we will do is charge you $100 per buy and sell in the commodity that we put you in.

And, of course, the operation then churns the account. Boiler-room and churning salesmen tend to recycle themselves through the industry, as you can see through this chart. Many of us know each other. Many of us have worked at different houses. Certain commodity houses have acted as academies for the inner corps of commodity salesmen. The three most prominent of these, to my knowledge, is First Commodity of Boston, Crown Colony, and Chartered Systems.

If you put all the dozens of salesman together who went through these houses, you would have a very elite corps.

I do not think there are easy and quick remedies to the problem of the commodities fraud. It is my experience that neither law enforcement or the Commodity Futures Trading Commission frighten houseowners or salesmen. Several States have tried to act quickly in shutting down houses. If that type of pressure could be kept up, it might begin to deter operators from opening up new houses.

One area where enforcement is terribly soft is the prosecution of salesmen. A consistent supply of salesmen who are not afraid of being caught is the lifeblood of this whole business. Without them, there would be no business. If the salesmen were consistently prosecuted along with the operators, I think it would make a very different situation than that which is before you today.

I think the most workable method of closing down the big operators is through putting long-term investigators in their houses. This, of course, would allow law enforcements to get the owners and also the salesmen and also spread paranoia through the business.

Senators, first I would like to commend you on what you are trying to do here today, but I personally feel you will be unsuccessful in curbing these commodity frauds. Your investigators were thorough, but to no fault of their own, they were limited to the depth of information they were able to obtain. I think this will make the difference between success and failure. You are dealing in some cases with sophisticated individual that will always be one step ahead of the law. The only way to stop some of these individuals is to be able to extract direct testimony against them. Their schemes are so sophisticated that the CFTC and the Justice Department have difficulty prosecuting them because of their inability to break through the fraud. Some of these frauds entail overseas affiliations. When I first met with your investigators, I told them I would be able to give them current information as well as information on past commodity frauds that were going on today. Some of the information—I requested immunity on certain individual frauds that I could give them information about. Although they were interested and much desired this information, they did not give me this immunity. Because of certain areas I will not discuss today, this subcommittee will not uncover all areas of sophisticated fraud in the commodity markets that are today bilking the American public out of tens of millions of dollars.

I am sure other witnesses feel today as I do who are testifying before this subcommittee. This is one of the reasons that you will be limited to the information that you will receive. It seems to me that most of the information we will hear will be an inside look on past commodity fraud and that you will be missing an important view of some present and future frauds in the works and that are being planned.

Senators, as I said earlier, these individuals are one step ahead of the law, and as you try to plug the leaks, they are opening up new ones.

Some of these individuals are of the highest profile in the commodity frauds, but the law enforcement agencies to date have been unable to close them down. If they are successful in closing them down, all they can do is give them a slap on the hand. Some of these individuals have done their schemes so discretely that they are not even known to the law enforcement agencies.

To this day, these scam artists are stealing from the public, as I said, millions of dollars, and because immunity is not given to individuals, they will not be exposed with direct testimony that can lead to prosecution and also give you an indepth look into the unbelievable scams going on.

From my understanding of how the Commodity Futures Trading Commission starts an investigation, it is usually from customer complaints. When enough customers complain, an initial investigation is started.

Now, I will tell you there are commodity frauds going on today taking in hundreds of millions of dollars, and there will never be customer complaints. Why? Because these investors are looking to lose their money. For every million dollars that is invested in these commodity frauds to lose, the U.S. Government loses $2 million in tax revenues. If you multiply that out, you are talking about hundreds of millions of dollars lost in revenues to the U.S. Government and this is only through a sophisticated commodity fraud. Where does the money go? It goes into the promoters who are selling these deals. This scam is the most sophisticated and most lucrative of all the commodity frauds around today that I have seen. I will also say it has gone on for several years quietly and is just starting to be copied by boilerrooms throughout the United States.

I offered, again, more details about this scam to your investigators, but, again, I was not given immunity. Since then I did not quit. I have even tried for your staff to contact someone in the Justice Department. It has been almost 3 months since your staff has made a contact and no one has even contacted me in reference to the information I have. Some individuals, like myself, have learned their lesson and do not want any more problems with the U.S. Government and are willing, with proper protection, to open up and expose these frauds.

This statement, Senators, which I have prepared is just some of the reasons why I believe you will not be able to stop the commodity problems that are draining Americans of their hard-earned money and, in some cases, their last dollars. Thank you.

Chairman ROTH. Mr. Waggoner.

Mr. WAGGONER. Mr. Chairman, I will just read a statement.

My name is Richard Waggoner. I am presently serving a 3-year sentence in a Federal penitentiary on charges of fraud arising out of my part in setting up and running a commodity fraud scheme. I have also been sentenced to 4 years, to be served concurrently, in a State penitentiary for a previous commodity scheme.

I have been involved in commodity operations since 1976. I began my career as a high-pressure boilerroom salesman, moved from there into managed accounts, and eventually set up two separate commodity sales networks. In the latter case, I set up the network structure and left the actual recruitment and operation of the sales forces to wholesalers and retailers throughout the country. I have come before the subcommittee today to describe these operations and offer whatever assistance I can to deter these types of abuses in the future.

I obtained my first experience in commodities with the firm of Economic Systems, Inc., in Century City, Calif. As far as I know, this started out as a legitimate commodity operation selling London options. I became Economic's top salesman and gradually began managing one person's account exclusively. The owner of Economic Systems initially invested this person's money, but I eventually took control of his investments and became a partner with the owner of Economic Systems.

Over a period of 2 years, we lost about $10.5 million of this one investor's money—a little legitimately and most not so legitimately. Even though we were losing client's investments, we had a computer system set up that we rigged to show that he was making significant profits. It eventually got so bad that we made up a story that his funds were actually being invested in a front company for the Central Intelligence Agency which was to explain why we could not give him complete access to his funds. When we were into him for several million, we decided to destroy all his records regarding his dealings with us and blame it on the CIA. When we had finished with this client, we had depleted his over $12 million estate down to $500,000.

In 1978, while all this was going on, my partner and I decided to form a commodity operation dealing in currencies. Based on past experience, we decided we needed to follow the following principles:

No. 1, use a nonstandard contract, and these are principles that most sham operations use.

No. 2, use an unregulated commodity.

No. 3, provide for a minimal downpayment to give the appearance of a purchase.

No. 4, create a phony offshore supplier of the commodity.

And No. 5, use the boilerroom technique.

We, therefore, set up an operation known as SMI. That stands for System Monetary International. We told our wholesalers and retailers at SMI that the currency was backed by a centuries old currency house in Europe. In fact, there was no such house, and we had no intention of buying any currency whatsoever.

Our plan was to sell currency for future delivery with a 10-percent downpayment and a 90-percent service fee. A $2,000 sale would consist of $1,800 in service fees and a $200 downpayment on a $10,000 contract. We correctly anticipated that any currency we would sell would never appreciate enough for the customer to make any profit. We helped insure this by selling currencies that had topped out or that had a very flat market, such as the Mexican pesos.

Finally, we assumed that we could ponzi any paybacks that became necessary. Though we explained the commission arrangement to our clients, we minimized it by stressing that the most they could lose would be their initial investments whereas they had an excellent possibility of making large profits.

Though the service fee was explained in our brochure, about half of our sales were made on the first phone call before the customer ever saw any literature. SMI was therefore, a two-pronged fraud. We were selling naked, uncovered currencies and due to an exorbitant fee, profits were virtually impossible.

Once we got started, we left many of the details of the operation up to our wholesalers and retailers, none of whom knew the operation was a sham, although many suspected but they could probably care less. Our involvement included having phony orders and confirmations sent daily from London monitoring our investors' positions to insure none were getting to us with profits and dictating what currencies should be pushed.

We were also heavily involved in promotion. We would go on television and interview each other as experts discussing how currencies were moving in response to world economic and political forces. We had our salesmen use similar lines, stating that certain economic pressures of the previous weeks would move a certain currency up quickly.

We also created a false demand by telling clients that we had only been allocated a certain amount of a given currency and once that was sold, their opportunity was lost. These and other factors brought tremendous pressure on people to buy on the first phone call. When I say pressure, I mean tremendous pressure. Of course, it was all pure fabrication. Nonetheless, many people bought before they hung up on the first phone call, and soon our cash flow became phenomenal.

SMI was 20-percent owned by a Panamanian lawyer we had retained and 40-percent owned by my partner and myself, respectively. The Panamanian was the only person on record, and, thus, we were shielded from view. He also backdated the incorporation papers of our company and gave it a totally fabricated large net worth. He then had a CPA friend of his falsely attest to the accuracy of the financial statements. These statements were primarily to our wholesalers and retailers to convince them of our legitimacy and solvency.

In addition, he set up several other companies for us to use to thoroughly launder funds back to us so that we would be totally insulated from the commodity scam. As an example we took commodity funds, ran them through several companies in Panama and Europe and then back to us as a loan to be used to purchase a ranch.

By the end of 1978, the operation brought in over $3 million by selling 900 contracts; 30 percent of the money was diverted to our accounts in Panama. Shortly thereafter, we were closed down by California authorities who claimed that what we sold was a security. We immediately sold out our clients' accounts and, as a result, we wound up with about $160,000 equity liability to those clients. As we had always depleted our accounts, we had to look to other sources to pay the clients off.

It was from this that the next and biggest and last scam was born, Comercial Petrolera Internacional. We knew that to start another operation would require us keeping our sales force, wholesalers and retailers in place. They, as yet, did not know the sham nature of our currency operation, although they suspected it, and to keep that organization intact would require us to pay off all their open clients. This we did with our new scam.

CRUDE OIL

In early 1979, we devised a scheme to sell crude oil for future delivery using the following principles:

We knew the product would have increasing demand; the CFTC knew little, if anything, about crude oil; crude oil had a complicated offshore business bid/ask price structure that few would understand; we drew up a contract which strictly limited our liability; and we, again, organized a captured offshore supplier with a totally fabricated financial structure.

With this operation, we arranged for our retailers to keep 50 percent of the sales, our wholesalers would keep 20 percent of the remaining 50 percent with an additional 5 percent to be hidden in Panama, which we never did, and the balance was to be split between me and my partner, the Panamanian attorney.

The crude oil scheme was very similar to the currency deal in that we again used our Panamanian arrangements and kept our names out of the picture. However, in the crude oil operation, we took further steps to convince our wholesalers and retailers of our legitimacy. For example, we had a totally phony Dun & Bradstreet report made up by a Dun & Bradstreet representative in Panama showing our net worth to be about $15 million. However, this time we made the company Iranian based and, thus, the financial statement being before the Iranian revolution could in no way be verified. We, again, had the phony financials certified in Panama. We also obtained a letter from a branch of a large Spanish bank in Panama attesting to our six-figure line of credit and our longstanding relationship with the bank.

We planned to use a composite of Platt's Oilgram and spot crude oil prices from a Rotterdam source to price our oil. In actuality, we priced it at whatever we needed to make a good profit as the pricing of crude was too complicated for the average layman to figure out anyway.

[At this point, Senator Chiles entered the hearing room.]

Mr. **Waggoner**. In attempting to avoid several of our currency operation pitfalls, we designed a brochure which made it clear we were only selling the ability to purchase crude as opposed to the actual commodity or the right to buy the commodity. We also clearly stated the risk factor, though we kept the actual product description vague. I mean very vague. I assume our customers thought we were buying a specific amount of crude oil for a specific price at a particular date. Of course, we never bought any crude for anyone.

We assumed, in setting up the crude oil scam, that oil had reached its peak in 1979. We, therefore, assumed we wouldn't have to cover any of our sales. However, if we had, we were prepared to, again, ponzi any contracts needing coverage. In fact, when the Iranian situation got hot, it looked like oil might go up and, therefore, put us in trouble. To remedy this problem, we shifted to a heavier class of crude, lowered the prices and informed our customers that that particular crude wasn't moving like we expected it to.

We made 400 sales totaling over $4 million. However, by December 1979, the oil scam was also under investigation, this time by Federal authorities. Our currency operation had been closed in June 1979 by State authorities who were quickly joined by Federal authorities, our old client from Economic Systems days was almost out of money and now the oil scam was under attack. With all this coming to a head, I decided to get out of the business and out of the country. I, therefore, became a fugitive from investigation and later from indictment.

After traveling to Costa Rica, London, Paris, and Mexico, I decided to return to the United States and turn myself in to the authorities after about a year and a half. I was subsequently prosecuted and sentenced, and I am now serving my Federal sentence.

Chairman ROTH. Mr. Levin, in your testimony, you alluded to some cases where the schemes were going undetected because neither the victim, if I understood you correctly, nor the operator had any financial reason to want to expose the situtation. I assume you are talking about some kind of a tax shelter.

Mr. LEVIN. That is correct. There are tax shelters in different areas. Some are more specifically involved with commodities.

Chairman ROTH. Would you please explain how they would operate?

Mr. LEVIN. I will give you a brief summary of how some of them do operate.

A client, of course, is investing in a business which is an offshore business outside of the United States. It could be Caymans, Bahamas, Liechtenstein, Switzerland. A grantors trust is set up in the United States for the investors in which he invests in this trust. The promoters are the ones who handle the trust in setting it up because most of them are attorneys. The funds are then invested in an offshore partnership that does not have to file with the Internal Revenue Service in the United States. The only filing that is necessary is the grantors trust that files an addendum along with their 1041 or 1040. The money is then invested in the commodities markets in an offshore brokerage firm, because the laws are different in trading than the laws that are traded here in the United States, and to give you an example, if, in fact, you Senator, open up a brokerage account in Merrill Lynch and buy 100 ounces on a futures contract, when that gold is purchased, they must ticket your account number to that stamped purchase price immediately in the order room. Well, in Europe, they do not have to put your name to that purchase price for days, weeks, or months. The laxity of laws overseas in commodities make it very easy for investors to trade in the market or, I should say, the promoters trade their money in the market purposely losing it, but the system that they use, the investors lose their money and the investors have no idea of what is going on.

The promoters losing the market, which are documented on regular exchanges, they are actual trades; they are not fraudulent trades, but, on the other side, if they are selling 100 ounces of gold, they are buying 100 ounces of gold, the loss becomes zero and the profit becomes the promoter's. It is a little bit more entailed than that, but it is one of the most sophisticated I have ever seen.

Chairman ROTH. I understand from your earlier testimony that you have some actual knowledge of these schemes.

Mr. LEVIN. That is correct.

Chairman ROTH. I am going to instruct my investigators to look into this further.

Mr. LEVIN. I know they tried very much to obtain the information and were bending over backward trying to obtain it. They did a tremendous job in the information they did get, not only from myself, but other people involved. Again, to no fault of their own, they were certainly unable to go into certain depths because, for my own protection, I would not go into these depths.

Chairman ROTH. I guess what I am saying to you, Mr. Levin, is I will instruct them to discuss it again and, if necessary, we will call you before this subcommittee under oath at a later date.

Mr. LEVIN. Right, Senator.

Chairman ROTH. One of the questions I would like to ask you, Mr. Waggoner, is how did you get on to the people in Panama with whom to deal?

Mr. WAGGONER. Mr. Chairman, in, I believe it was 1977, I needed some type of bearer share corporation, that is, a corporation that you can't trace the ownership to, to open a bank account. I had several million dollars in London that I wanted to move into another account. I had used Liechtenstein corporations again, which are bearer share corporations, and a Liberian corporation, and someone had mentioned to me that Panamanian corporations were good. So I was referred to a law firm called Theodore, Goddard & Sons, which is a large law firm in London, and they sold me a Panamanian company off the shelf. It was for $2,000. I didn't use it at that time. I put it away and some time in early 1978, I started thinking about the currency scheme. I remembered that corporation, looked up the corporation who incorporated it, Abagados Panamenos, which is a law firm in Panama, I called them on the phone, flew down there and that is how the relationship began.

Chairman ROTH. Mr. Levin, you mentioned that the life blood of these operations are the salesmen and that they are not actively prosecuted. Looking at the United States, are these boilerroom operations located in a limited number of places and are there a limited number of salesmen? Are the salesmen floating around, or is it easy to attract new salesmen?

Mr. LEVIN. The same salesmen are floating around. Most of our boiler operations are located in major cities—New York, Los Angeles, Texas, a few in Phoenix, but there are scattered around the country very small operations, Chicago and Boston. Ninety percent of them are the same commodity brokers who circulate. You do get a recruit of new brokers, fellows out of high school, the younger crowd that they are able to take in trade.

Chairman ROTH. Are you saying to me then at least theoretically if you could get a hold of those six or eight locations, plus the sales people that float from operation to operation, that you might be able to regulate or control the bulk of this?

Mr. LEVIN. The lifeblood, again, is the salesmen. If the salesmen were stopped and there was a case just recently where the State indicted not only the owner but 30 of the salesmen of a strategic metals firm in New York. Until that time, there has never, to my knowledge, been any salesman indicted, and if you don't indict the salesmen, they have the ability to go on freely earning the kind of dollars they earn—some average $5,000 to $10,000 a week in income—you are not going to stop anything. You hit them at the heart is the only way to stop them.

Chairman ROTH. I ask both of you gentlemen, how would you compare the frequency of commodity fraud scams today with 5 years ago? Mr. Waggoner?

Mr. WAGGONER. I think it has become much more sophisticated, as Ken Levin was saying. The tax scam is the waive of the future because you get nobody who complains. They are going into this scam to lose their money, essentially. They don't care if they lose their money. They want that writeoff. For $5,000, they might get an 8-to-1 writeoff, they might get a $40,000 writeoff. That is what is happening now. To answer your question, sir, it is only on the increase. It is not on the decrease.

I think London options 5 years ago were the big ones, but they have gotten much better since those days.

Chairman ROTH. Mr. Levin?

Mr. LEVIN. I feel today, again, as Mr. Waggoner stated, they are more sophisticated. What you are doing is you are getting maybe a handful, 30, 40 real sophisticated pros who came out of Wall Street into commodities who have now gone into setting up international corporations with jurisdictions in the United States and overseas.

I think with the new commodity proposals that are coming out on the futures exchanges, such as commodity options, futures on the stock indexes, I think you are opening up a new world to these individuals that are going to create even more sophisticated crimes than we have seen today.

Chairman ROTH. In other words, as you see these proposed changes, they are actually going to just complicate it, compound the problem seriously?

Mr. LEVIN. Absolutely. As I have said, I want no part of the commodities anymore. Then when I heard these proposals coming into effect in trading commodity options and the stock index, that was like putting a steak in front of my face.

Mr. WAGGONER. I have to disagree with that though, sir, on the new proposed legislation. I think just the opposite effect is going to happen. I think you have got to look at why London options were abused. They were abused because of the exotic nature of London options. You could not find the price, strike prices, you couldn't find out who the supplier was—they were offshore—and there was no limit on how much you could mark them up.

If you have an American option and you can freely see the strike price, you take the economics out of this scam. In other words, I can't mark up an American option 100 percent or even 20 percent. Merrill Lynch can sell it for exactly what they buy it for on the floor and charge 5-percent commission. I don't think you will see the big bugaboo you saw with London options. I don't think that is what you have to worry about. You have to worry about the exotic investments like strategic metals or especially tax frauds, tax shelters, to be specific.

[At this point, Senator Nunn entered the hearing room.]

Chairman ROTH. Let me point out, you can also see the price of gold, yet people still buy.

Mr. WAGGONER. Yes, people do buy it, but the people who lost their money bought an exotic investment around gold. They didn't go buying gold on the futures market or go buy the actual physical. They went to buy a leverage contract, deferred delivery contract, an option on gold, all of which were illegal.

Chairman ROTH. My last question, between 1977 and 1980, I would ask both of you to answer this question: Did you ever see the CFTC? Does the industry worry about CFTC today?

Mr. LEVIN. Well, Senator, in one of my companies that I had formed in 1978, the CFTC did walk in the door with, I guess, two investigators, asked for my books and records. I referred them to my attorney. My attorney simply told them we will not give it to you. Their reply was, "Thank you, we expected that," and since then never heard from them after that.

Chairman ROTH. Mr. Waggoner?

Mr. WAGGONER. Yes, Mr. Chairman. My experience with the CFTC has been one which was a little different. I think the CFTC was really behind the investigation that finally prosecuted myself, which was the oil scam, and although they have had a reputation of not being that competent, I found them to be very competent in their investigation. It was not so much they didn't have the expertise, it was they didn't have the manpower to go in and bust up these organizations. They did a good job with me.

Chairman ROTH. What about the State?

Mr. WAGGONER. Well, the State of California, which prosecuted me on the currency, was excellent. I think that may be one area to explore, giving more power to the States just because of the manpower situation with the CFTC. But, again, the State of California—one prosecutor in particular, Hugh Levine—did an excellent job of breaking up the currency scam.

Chairman ROTH. Senator Rudman.

Senator RUDMAN. Mr. Waggoner, when you started your company in California, did you register with the CFTC?

Mr. WAGGONER. Senator, I believe I was already registered with the CFTC. In an earlier company I was involved with, called Euro-American Commodities, I did not register. I don't believe I registered International Currency Exchange with the CFTC.

Senator RUDMAN. How about your oil scam? Did you register that?

Mr. WAGGONER. No, neither one. We were unable to register. They didn't fall within the realm of the jurisdiction of the CFTC.

Senator RUDMAN. So, essentially there was no registration at all?

Mr. WAGGONER. Yes; that's correct, sir.

Senator RUDMAN. So essentially there was no registration at all?

Mr. WAGGONER. Yes; that's correct, sir.

Senator RUDMAN. How much money did those two companies handle, the California companies, over the period of time you operated them?

Mr. WAGGONER. Close to $10 million. Between $8 million and $10 million.

Senator **Rudman**. The reason I ask the question is, in your testimony you indicated that one client lost about, I believe, $10 million with your company.

Mr. **Waggoner**. He lost close to $12 million, but that was one very eccentric person who had a lot of money and who was involved in many different things besides commodities with me.

Senator **Rudman**. If he lost $12 million, I don't understand your prior answer that you only handled $10 million because, if I understand your testimony correctly, you would have handled $12 million with just one customer.

Mr. **Waggoner**. This customer had nothing to do with the currency company or the oil company. This customer was involved in the beginning in investing in commodities through Economic Systems, which have nothing to do with the numbers that I gave you.

Senator **Rudman**. How much money did Economic Systems handle during its brief lifetime?

Mr. **Waggoner**. Probably close to $20 million.

Senator **Rudman**. What precipitated the action of the State of California to move against you initially?

Mr. **Waggoner**. We had an office in San Francisco. The policy, as the policy is with most commodity fraud companies, is to pay back the client. If the client has a complaint, give him his money back. There is always enough money to keep. That is usually the policy with the owners. Most of the time when you have small agencies around, they don't follow that policy. Someone complains, they tell them, "Well, that's too bad." That person will either go to—these particular people went to the district attorney's office in San Francisco. That is where it started an investigation.

Senator **Rudman**. Approximately how long after they went to the district attorney's office in California, to your knowledge, was there action brought against your company?

Mr. **Waggoner**. Well, they came and got the records about 3 months ago—the State of California did after they started the investigation and indictments followed 6 months later. So it was a 9-month total time.

Senator **Rudman**. So, essentially, within 1 year of the time someone had complained to California State authorities, action was, in fact, taken and your outfit closed.

Mr. **Waggoner**. Yes; it was very swift.

[At this point, Senator Roth withdrew from the hearing room.]

Senator **Rudman**. So your experience, certainly, in that instance was that the local authorities, in this case county as opposed to State, acted with great speed and alacrity in closing you down.

Mr. **Waggoner**. That has been my experience.

Senator **Rudman**. How long did the experience take with the CFTC that you later endured?

Mr. **Waggoner**. Well, at that time, I was offshore. I was living in Panama, and I believe it was probably in November 1979—when we started noticing, we had some heat—it was in November 1979. The indictments took well over 1 year. They took until—well, not actually—they took until May 1980. It wasn't over a year. They were a little slower, but I think they had a larger case; they had a lot more things to look at.

Senator **Rudman**. What effect did the California and the CFTC actions against you and your companies have on those associated with you in the industry in California?

Mr. **Waggoner**. I wouldn's say it had much of an effect. The industry learns by the people that lose, and tries to get more sophisticated. That would be the only effect. I don't think it had absolutely any deterring effect, even though some of the sentences in my own case were pretty stiff, I thought.

Senator **Rudman**. How long is your sentence?

Mr. **Waggoner**. Four years.

Senator **Rudman**. Where are you serving?

Mr. **Waggoner**. Serving at Lompoc Federal Prison.

Senator **Rudman**. Mr. Waggoner, during the time you ran these two companies, how much money did you personally draw out of this company in California, expenses and so forth?

Mr. **Waggoner**. Out of the currency company, it was—my partner and myself personally was about $600,000. Out of the oil company, it was about $500,000, and out of the Economic Systems, it was about $6 million.

Senator **Rudman**. $6 million.

Mr. **Waggoner**. Yes.

Senator **Rudman**. Out of the Economic Systems that you drew personally?

Mr. **Waggoner**. Personally.

Senator **Rudman**. Did you file tax returns on all those funds?

Mr. **Waggoner**. I filed 1978 tax returns, and from that I haven't filed any tax returns as a fugitive starting in 1979.

Senator **Rudman**. What year did you draw the $6 million, or what years?

Mr. **Waggoner**. Probably through 1977, 1978, 1979.

Senator **Rudman**. Are you indicating to me you paid taxes on some of that $6 million, the portion you received, and did not pay taxes on others?

Mr. **Waggoner**. Well, the history of what happened to the $6 million would make it pretty hard to pay taxes on it. A lot of it was lost. A lot of it was invested and lost, but I paid no taxes on that money, although I don't know what my tax liability would be. I doubt if it would be much.

Senator **Rudman**. Have you ever been interviewed by the Internal Revenue Service since you have been at Lompoc?

Mr. **Waggoner**. Yes; not since I have been at Lompoc—but, yes, I have at Lompoc.

Senator **Rudman**. Essentially, what you did, you and your partner over this period of time took somewhere around $7.5 million—$6 million out of these companies for your own use, invested it and lost it yourself.

Mr. **Waggoner**. Not only did we invest it, we also had it stolen from us. About $3 million was stolen through another commodity operation.

Senator **Rudman**. I kind of figured that, Mr. Waggoner. I was trying to get you to say that. So actually you ended up being caught on your own hook.

Mr. **Waggoner**. Yes; that is exactly right.

[At this point, Senator Chiles withdrew from the hearing room.]

Senator RUDMAN [presiding]. Senator Nunn.

Senator NUNN. Pursuing that, what kind of operation were you caught in? Where did you lose your money?

Mr. WAGGONER. There was a brokerage house in Paris, and a certain gentleman by the name of Richard Charpeat—who is a current fugitive from the Parisian authorities—had the idea we could corner the lead market, not to the same degree the Hunts did, but the lead market was much smaller. We thought we could do that in London. He had a bearer share company, some German name, Aunschstahl [sic] of London. I invested $3 million into that company. He was supposedly going to put up the other $3 million. We used a bearer share company because I didn't want the authorities to know I had that money which put me in kind of a compromising position, and when it came time to draw the money out, he said there was no money, using the exact same techniques we use with clients of our own. When I said I was going to complain, he said, "Fine, complain," as I could not talk about the money I had anyway.

Senator NUNN. This was a Frenchman, someone domiciled in Paris?

Mr. WAGGONER. Yes, but I later did go to the London fraud, squad, gave a full statement, sued the person, and he is currently being sought after by both the London authorities and the French authorities.

Senator NUNN. So he never really invested that money.

Mr. WAGGONER. No, he took the money. As a matter of fact, we got the records of the money through a brokerage house in London. We found he used part of the money to purchase a ranch from us, part of our own money, clients' money and used the other money just for himself.

Senator NUNN. How would someone of your experience, when you are conducting the same kind of thing, get taken in by that scheme?

Mr. WAGGONER. The person I am talking about was a partner at that time. We had known him for quite a while. It was pretty easy to get taken in. As a matter of fact, we had gone to New York with this money, and we were granting option; we were heavily involved with him. The only security I guess we had with the person was that we were both thieves, and we thought there would be some honor among thieves, and there wasn't.

Senator RUDMAN. Senator Nunn, I wonder if you would yield? Did he register a complaint with the CFTC?

Mr. WAGGONER. No, I threatened to do that, but it had little effect.

Senator NUNN. This was an international transaction; right?

Mr. WAGGONER. Yes.

Senator NUNN. Who do you complain to on an international transaction like that?

Mr. WAGGONER. We went to the London fraud squad.

Senator NUNN. Did the transaction occur in London?

Mr. WAGGONER. Yes, it occurred in London and in Paris. We went to the Parisian authorities also.

Senator NUNN. Would the CFTC have had any jurisdiction over that particular transaction?

Mr. WAGGONER. No; not at all. They probably would have been interested in what was going on. That is one of the problems, that most of the larger commodity frauds are done in Europe, especially the tax frauds, as Ken was talking about.

I can arrange very easily to lose any amount you want on a commodity exchange in Europe; pay the person who is doing it maybe 20 to 30 percent, and the other 70 percent winds up in a Swiss account.

Senator NUNN. So you are saying most of the big fraud is taking place in Europe?

Mr. WAGGONER. I would say a lot of big fraud is taking place in Europe—I wouldn't say most.

Senator NUNN. Is there any remedy for that within the laws of the United States, that you know of?

Mr. WAGGONER. It would be pretty tough to regulate markets overseas. I think the only remedy is having people tell you what is going on at that point.

Senator NUNN. A reporting system?

Mr. WAGGONER. A reporting system.

Senator NUNN. When you invested that $3 million that you yourself feloniously acquired, did you write a check, or did you deal in cash, or did you deal in a cashier's check? What mode of currency transaction?

Mr. WAGGONER. There was a $2 million wire transfer from a bank in Switzerland to a bank in England and 1 month later, there was an additional $1 million transfer from a bank in Switzerland to a bank in New York.

Senator NUNN. Did you have the money invested in your own name?

Mr. WAGGONER. No, the money was held in what is called Aunschstahl [sic] which is a Liechtenstein company, bearer share company in a bank in Switzerland. My name wasn't on the account. That is the way it is usually done, by the way, overseas.

Senator NUNN. Bearer share?

Mr. WAGGONER. Bearer shares; whoever owns the shares, owns the company. There is no name on the share.

Senator NUNN. Physical possession is tantamount to ownership?

Mr. WAGGONER. Yes.

Senator NUNN. That is vulnerable to theft, and so forth, would it not be?

Mr. WAGGONER. Yes, but that is not usually the problem. Most shares are kept, usually, in a safety deposit box, and the companies are usually run by reputable attorneys in Switzerland or Liechtenstein or Panama.

Senator NUNN. When you were dealing in the United States, did you use offshore connections to launder money or to funnel money through?

Mr. WAGGONER. Always.

Senator NUNN. Where were those offshore bank accounts?

Mr. WAGGONER. We had some accounts in Panama; we had accounts in Luxembourg; we had accounts in Switzerland. We liked the accounts in Panama usually the most because the Panamanians were very secretive; they made you feel secure that there was absolutely no way you could find information out about the accounts. Switzerland had gotten a little lax, and Luxembourg was a little slow, but very good.

Senator NUNN. When you say Switzerland had gotten a little lax, you mean they were beginning to cooperate internationally more about information swaps, and so forth? What do you mean by lax?

Mr. WAGGONER. Exactly that. I don't think they were so nervous to get the business. They had already established themselves so they would cooperate if there was any pressure put on them, I thought.

Senator NUNN. You filed a tax return in 1978. Did you show your full income on that tax return?

Mr. WAGGONER. I filed a tax return in 1977, not 1978. In 1977, I showed my full incomes. In 1978–79, I was in kind of a quandary whether to file. I knew if I filed, I would have to lie, and if I lied, it was much worse than if I didn't file. So I decided not to file.

Senator NUNN. But in 1977 when you filed that return, you did show everything you had taken in?

Mr. WAGGONER. Yes.

Senator NUNN. It was an honest tax return?

Mr. WAGGONER. Pardon me?

Senator NUNN. It was an honest tax return, as far as you were concerned?

Mr. WAGGONER. Yes.

Senator NUNN. Why did you make that decision at that time? Did you feel the IRS was going to get you for not filing at all? What was the motivating factor?

Mr. WAGGONER. Excuse me, sir—why I made the decision?

Senator NUNN. To file the return in 1977.

[At this point, Senator Roth entered the hearing room.]

Mr. WAGGONER. In 1977, most, in fact, all of our business was pretty well legitimate, and I hadn't earned a great deal of money by the time I filed that tax return. There was no problem.

Senator NUNN. That was not the return that would have showed the $6 million, $400,000 or the $500,000?

Mr. WAGGONER. Nothing like that.

Senator NUNN. When did those earnings take place?

Mr. WAGGONER. 1978, 1979.

Senator NUNN. And you did not file a return on those?

Mr. WAGGONER. No; I did not.

Senator NUNN. Was that because you were a fugitive or because you didn't want to be in the position of reporting that much income?

Mr. WAGGONER. Well, I was a fugitive. I didn't know how to go about reporting the income. I knew if I did report a large income—if I didn't report a large income, I would be lying again and would cause serious problems.

Senator NUNN. You said a few moments ago, if I understood your testimony, that CFTC people you dealt with were rather competent; is that right?

Mr. WAGGONER. I felt them to be very competent.

Senator NUNN. You said the main problem was the lack of manpower; is that right?

Mr. WAGGONER. The lack of manpower; that is right, sir.

Senator NUNN. Mr. Levin, what is your attitude toward that? What is the main problem of the CFTC as far as you are concerned?

Mr. LEVIN. There is definitely a lack of manpower and lack of funds, but I don't believe that they have the knowledge and experience as, say, the Securities and Exchange Commission attorneys, and to give you an example, I know several law firms that were, in fact, in a case against the CFTC versus a client of theirs and where the CFTC was starting to win the case, the law firm that was on the opposite end, the clients on the opposite end would hire the CFTC attorney from the CFTC, of course, the case being lax at that point since he knew he had joined the firm, the one he was attacking.

Senator NUNN. The attorney would go directly from working on that case to the law firm. Would he work on the case for the law firm or were they hiring him to get him out of the way?

Mr. LEVIN. They would make a proposal to hire them when the case is done, within a certain period you will join our firm. Of course, I have seen them in cases become very lax when this happened.

Senator NUNN. What I am getting at, did the lawyer for the CFTC go to work for the firm during the pendency of the case?

Mr. LEVIN. No, after.

Senator NUNN. But you are saying the deal was made while the case was actually being prosecuted?

Mr. LEVIN. Absolutely. That was the best advantage for the attorneys who represented the clients.

Senator NUNN. So, in effect, the attorney representing the CFTC had a very flagrant conflict of interest.

Mr. LEVIN. That is true. No. 1——

Senator NUNN. Have you given that information to the authorities?

Mr. LEVIN. I think I sat with the investigators—I mentioned that.

Senator NUNN. To our committee?

Mr. LEVIN. Yes.

Senator NUNN. Names and so forth?

Mr. LEVIN. No, I don't think I mentioned any names.

Senator NUNN. Do you have any names?

Mr. LEVIN. None that I would mention right now.

Senator NUNN. You know the names yourself, though?

Mr. LEVIN. Yes; it is a common practice with the CFTC.

Senator NUNN. More than with other Federal agencies?

Mr. LEVIN. Well, I am not familiar with other Federal agencies other than the Securities and Exchange Commission. Starting on Wall Street in 1964, I have been somewhat familiar, and I have never heard that happening in the Securities——

Senator NUNN. You are saying it is a common practice with CFTC employees or attorneys to be hired at the time of prosecuting commodity fraud cases to go to work for the same law firm that is defending the case?

Mr. LEVIN. Right. You have to understand, Senator, that the law firms who hire them away are the most common law firms protecting the criminal individual or proposed criminal against the Commodity Futures Trading Commission. There are only a handful of law firms that handle these men.

[At this point, Senator Chiles entered the hearing room.]

Senator NUNN. There is a great distinction being hired after a case is over and being hired during a pending case. In one case, it is a common practice; in another case, it is a conflict of interest, in my view, and would violate the Federal law. You are saying it is the latter, are you not?

Mr. LEVIN. I am not saying in my eyes there is any violation of Federal law here because they are being hired after the case is finished.

Senator NUNN. But aren't you saying they are hired during a pending case while they are making the contract to be hired?

Mr. LEVIN. Well, to my knowledge, yes, that is when the discussions do start during the case, because at that point is when the meeting of the two attorneys from different sides meet, become friendly and see whether they want to come over.

Senator NUNN. Do you have evidence of that?

Mr. LEVIN. Nothing in writing; no.

Senator NUNN. Just a suspicion?

Mr. LEVIN. A knowledge; it's a common knowledge. It is a common knowledge to many salesmen.

Senator NUNN. What do you say about the lack of manpower with the CFTC?

Mr. LEVIN. They do have a lack of manpower, and they do have a lack of dollars. In my position in the commodity fraud that I ran, I was certainly not afraid of the CFTC, nor was I afraid of the State even though the State was certainly most effective in closing us down because they were the ones who came in with the cease-and-desist order immediately. But, of course, all that did is just let us move to a different State and continue operating.

With the CFTC, they just had no capacity to come in and do anything to us other than a civil injunction in the Federal court system of New York, southern district, but, again, we were not worried about that, nor were any of the boilerrooms worried about the CFTC. They were more worried about "60 Minutes" walking in the door.

Senator NUNN. More worried about "60 Minutes" than about the CFTC?

Mr. LEVIN. Absolutely.

Senator NUNN. Why is that? Did you have experience with "60 Minutes"?

Mr. LEVIN. No; I never had experience with "60 Minutes," but many boilerrooms have had experience with "60 Minutes" and you certainly never want to be caught on camera because your name becomes more known to the public, publicity, on the TV.

Senator NUNN. Certainly "60 Minutes" doesn't have as many people working for it—investigators—as the CFTC.

Mr. LEVIN. That is true, but they get national publicity.

Senator NUNN. The fact you would be exposed nationally, even if you weren't prosecuted, would be more of a threat to you than the actual prosecution?

Mr. LEVIN. That's true.

Senator **Nunn**. Why? Do you feel that you are pretty well buffered against prosecution?

Mr. **Levin**. I really believe up to 1979, Bartex was really the first case that became a major prosecution. Up to that point, the CFTC has never hurt anybody other than slap them on the hand.

Mr. **Waggoner**. Lloyd Carr.

Mr. **Levin**. Other than Lloyd Carr, who is another big one. As I stated in my testimony, one of the successors of British American, who is one of the largest commodity option houses in the United States, the successors took it over and the day before they got word the CFTC was coming to freeze their bank accounts, they stole the customers' double suggestion money. All they got was a slap on the hand. I think they signed a consent order. This is going back to 1978.

Senator **Nunn**. Did you file tax returns during the period of time you were conducting this kind of commodity fraud?

Mr. **Levin**. Yes, I did.

Senator **Nunn**. Did you file honest tax returns?

Mr. **Levin**. Yes, I did. Of any fear I have, it is the IRS.

Senator **Nunn**. The IRS is your main fear?

Mr. **Levin**. That has always been my main fear. That is one area I try not to cheat. Their investigators are too strong. It is like the eyes of Big Brother is watching you.

Senator **Nunn**. Did you file the source of the income or just the income?

Mr. **Levin**. Source of the income also.

Senator **Nunn**. How did you label that?

Mr. **Levin**. Basically, all my money was taken in the United States in check form from the corporation. I was basically to the corporation—I was hired by another corporation which was a consultant to that corporation. I was an employee, so everything I took——

Senator **Nunn**. Salary?

Mr. **Levin**. Salaried or basically commissions.

Senator **Nunn**. What kind of salary or commissions were you drawing, say, for instance, in a normal year?

Mr. **Levin**. Approximately $100,000.

Senator **Nunn**. About $100,000?

Mr. **Levin**. Yes, in that area.

Senator **Nunn**. Was that based on a percentage of the profit?

Mr. **Levin**. No, that was just based on whatever I wanted to take.

Senator **Nunn**. Because you actually controlled the draw?

Mr. **Levin**. That's correct.

Senator **Nunn**. Did you report the corporate income, too?

Mr. **Levin**. That's correct.

Senator **Nunn**. And the corporation filed a return also.

Mr. **Levin**. That I don't know. I was not a corporate owner, and I did not run the corporation. Then when the books and records were confiscated by the Government, turned over to the Government, I don't know the accountants had prepared at that point—what tax returns they did prepare. Again, not being an officer of the corporation, I did not have to sign anything.

Senator **Nunn**. If you weren't an officer, how was it you could determine want your own draw was in the corporation?

Mr. LEVIN. Because I was basically one of the individuals running the show. In the industry, it is very common you put somebody up front for you basically to shield you.

Senator NUNN. So you had a lot to say about the draws.

Mr. LEVIN. That is correct.

Senator NUNN. Did you control other people's salaries, too, or just yours?

Mr. LEVIN. Secretaries, of course, but what I took, so did everybody else.

Senator NUNN. So you sort of set the pace?

Mr. LEVIN. Yes, or either someone else would set the pace. If you needed more money that week, you would take more money that week, and it would come off your side of the balance sheet, basically, so the other partners would even up.

Senator NUNN. You were more fearful of the Internal Revenue Service during this whole period than any other governmental agency?

Mr. LEVIN. That is correct. Always has been. That is one thing I have always done is have accountants prepare my tax returns properly.

Senator NUNN. Thank you.

Chairman ROTH [presiding]. Senator Rudman.

Senator RUDMAN. Mr. Chairman, Senator Nunn has opened, I think, a very interesting line of questioning, but there are problems with going further with it. I want to just ask this witness two questions, and then make a recommendation to you, Mr. Chairman.

Mr. Levin, if I can summarize what I understand your statement to be about the practices of hiring lawyers from CFTC, what you essentially have told Senator Nunn in response to his question is that you are aware of certain circumstances of your own knowledge, but you are not aware of them because of any conversation in which you were a principal party to; is that correct?

Mr. LEVIN. That's correct.

Senator RUDMAN. In other words, what you are telling this subcommittee is that you surmise from what you know in the industry and from what you have seen that certain attorneys who are employed by the CFTC left the CFTC at the conclusion of cases to join the law firms which were on the other side of the case.

Mr. LEVIN. That's correct. Again, these lawyers are a small group, so each one knows each other and they certainly talk to each other. One might be my attorney in telling the situation, "Well, this CFTC attorney was prosecuting a client and he was taken over by that law firm and, of course, is presently working for that law firm."

Senator RUDMAN. If I could go one step further, what you then say is, based on your observation, you believe the vigor in which these cases were prosecuted after that deal, in your surmise, was made decreased to some extent.

Mr. LEVIN. Yes, in my eyes, yes.

Senator RUDMAN. Mr. Chairman, I think we have to be very careful not to libel good people and destroy their character, so I am not going to ask this witness this question today. He, of course, has no immunity. If we were to ask him that question, we could direct him to answer it because it does not involve any crime of his.

Rather than do that, I am going to ask you, Mr. Chairman, if you would direct the staff to get a detailed statement of names, places and dates so we can further look at this before following it any further.

Chairman ROTH. Yes; I shall so instruct the subcommittee. I think the suggestion of the Senator is a good one. We are going to followthrough on a number of other areas with him, so we will proceed accordingly.

Senator RUDMAN. Thank you.

Chairman ROTH. The witnesses are excused.

We are going to postpone Mr. Raymond Day until tomorrow because the hour is growing late.

At this time, I would like to call our next witnesses who will appear as a panel. They are Mr. Latham, securities commissioner from the State of Texas, Orestes Mihaly, assistant attorney general in charge of the bureau of securities for the State of New York, and Tom Krebs, the securities commissioner for the State of Alabama.

Gentlemen, if you will please rise and raise your right hand. Do you solemnly swear that the testimony you are about to give before this subcommittee is the truth, the whole truth, and nothing but the truth, so help you God?

Mr. LATHAM. I do.

Mr. MIHALY. I do.

Mr. KREBS. I do.

Chairman ROTH. Please be seated, gentlemen.

I would ask each of you, if you would, to summarize your statements. They will be incorporated in the record as if read in their entirety.[1]

Mr. Krebs is the one who will lead off.

TESTIMONY OF RICHARD LATHAM, STATE SECURITIES COMMISSIONER, STATE OF TEXAS; ORESTES J. MIHALY, ASSISTANT ATTORNEY GENERAL, STATE OF NEW YORK; AND TOM KREBS, SECURITIES COMMISSIONER, STATE OF ALABAMA

Mr. KREBS. Thank you, Mr. Chairman, members of the subcommittee. We represent, in addition to our individual States, the North American Securities Administrators Association. That association is composed of State administrators, securities administrators from the United States, each of the States, the Canadian Provinces, the country of Mexico, and Puerto Rico.

We request, Mr. Chairman, that our written testimony be inserted in the record of these hearings so that we might give you a short-form rendition of the remarks contained therein.[2]

Chairman. ROTH. Without objection.

Mr. KREBS. We commend the subcommittee for recognizing the national crime wave in commodities frauds which offers, permits opportunities for unscrupulous swindlers to take funds from unwary investors. We agree that since the preemptive language in the CEA that boilerroom operations have prospered in the United States.

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[1] See p. 189 for the prepared statement of Mr. Richard D. Latham.

[2] See p. 195 for the prepared statement of the North American Securities Administrators Association, Inc.

[At this point, Senator Chiles withdrew from the hearing room.]

Mr. **Krebs**. In addition, we witness daily the migration of thieves, con men and swindlers into this area for several reasons. Chief among these, we believe, is that State security administrators, those persons to whom the residents of our respective jurisdictions look to for protection of investors have been preemptive from the use of our securities laws or any securities theory in connection with these type investments.

We believe as well that the Commodity Futures Trading Commission, their staff has proven themselves wholly incapable of assuming the burdens prior to the action of the preemptive language used to protect citizens of our respective States.

By way of example. let me give you this one: In November 4, 1976, we prepared affidavits and documents and submitted them to the CFTC with respect to a specific area of criminal activity involving a major commodities trader, a London options trader and were led to believe by the CFTC that the losses were in excess of $37 million.

On January 7, 1977, we were contacted by the CFTC and asked whether or not they could use the documents we had provided them in their civil litigation involving the injunctive action against this firm involving the $37 million.

[At this point, Senator Nunn withdrew from the hearing room.]

Mr **Krebs**. On the 28th day of January, 1982, that action was dismissed in Federal court in Illinois, 6 years after, we had provided them with that type of information. This is not an unusual case, by any means. It is rather illustrative, we think, of the type of protective provisions or the protective services the CFTC has rendered in connection with this congressional mandate.

I will be prepared to answer any questions you might have about this or any other related case. Mr. Latham and Mr. Mihaly would like to offer a brief statement as well.

Chairman **Roth**. Please proceed, gentlemen.

Mr. **Latham**. My name is Richard Latham. I am the securities commissioner of the State of Texas. While I wear many hats and regulate many things, my primary response the would apply here is to put cons in the can. That is something that we pride ourselves on in the State of Texas, having the ability to police white-collar fraud in the investment area.

To give you some indication of our abilities, we first started hearing about commodity-like frauds, and I called it commodity-like frauds because most of these people are not in the commodity business, they are in the fraud business hiding under a facade, whether it be securities or whether it be commodities.

We were hearing about commodity options and London options. Our staff of about 12 attorney/investigators went to work on those that were operating in Dallas and Houston. We got 84 indictments against 28 individuals in the years 1973 through 1975. We ended up with 11 convictions, 6 permanent injunctions, and 4 receiverships to try to get some money back for the investors. What has happened in the interim is that the water has become very muddy because the Commodity Exchange Act Amendments in 1975 appeared to give exclusive jurisdiction over anything that touched upon a commodity to the CFTC, which, as you well know, has a very small, even though I think highly efficient, staff. It is simply not possible to police all of the fraud that is going on at the Federal level with a very small police force. I have probably half as many investigators in the State of Texas as the CFTC has nationwide. Their nearest office to me in Texas that handles complaints is in Chicago.

So basically what I am suggesting is that all of the testimony I have heard this morning from the victims is stories we have heard in Texas again and again and again. The stories from the promoters are stories I have heard again and again. We continue to do our job, but it is much more difficult to do it at the State level under the cloud of Federal preemption because, in addition to having to fight the crooks on their own turf, we have to constantly be battling the jurisdictional questions as to whether we even have any authority to prosecute them. Thank you.

Chairman ROTH. Mr. Mihaly.

Mr. MIHALY. I am Orestes J. Mihaly, assistant attorney general in charge of the Bureau of Investor Protection and Securities in the State of New York. I would like to make this short statement.

Attorney General Robert Abrams of New York is pleased that this committee is focusing its attention on a problem which we in New York have been concerned with for many years now. This problem involves the criminal activity being perpetrated upon the investing public by unscrupulous promoters operating out of so-called boilerrooms, primarily in New York City, but also in States such as Florida, New Jersey, Connecticut, Maryland, and Massachusetts. We are happy to cooperate with your subcommittee in connection with its study of the increasing fraudulent activity in the commodities field. Boilerrooms and bucketshops have existed for many years going back to the turn of the century. But since 1975, we have encountered fraud in the sale of commodities which far exceeds frauds in the trading of securities.

Our office has played a significant enforcement role in this area both before and after the enactment of the CFTC Act of 1974. I would first like to explain to you how the attorney general's office of New York State differs from the other State securities administrators.

Under the New York blue-sky law, the attorney general is given both civil and criminal jurisdiction to prosecute securities and commodity frauds. We may proceed in the civil courts for injunctive relief or, without the involvement of any other criminal prosecutor, initiate a criminal action, either by grand jury, by application for arrest warrants or by summary arrest of persons found by our State police investigators to be engaged in criminal activity.

Presently, our bureau has assigned to it approximately 15 assistant attorneys general who handle fraud investigations of all types. We have a staff of 10 forensic accountants and 6 New York State troopers and investigators with police officer power. We believe that, unlike any other State securites administrator, we have a unique knowledge of direct criminal prosecution in that area and a record we can take some pride in.

Since 1975, we have encountered the full gamut of commodity frauds, such as we heard testified to this morning by the gentlemen who were incarcerated in prison. From commodity options to London options, leveraged gold and silver contracts, the sale of so-called deferred delivery contracts in precious metals, heating oil, and the latest flurry of activity since the early part of 1981, the sale of strategic metals and minerals.

From our investigations and inquiries into boilerroom operations, it can be conservatively estimated that 100 boilerrooms come and go in New York alone during the course of the year. Indeed, these boilerrooms proliferate like the mythological "hydra." Individual boilerrooms may gross in excess of $10 million a year. While this amount is not the average, there is little doubt that there are tens of millions of dollars stolen from the public annually in New York alone. The national figures are even more staggering.

We have the exhibit here of the Commodity Club which shows this type of operation where there is hydra, where you cut off 1 head and 10 heads appear the next week.

In light of this serious situation, it is certainly not in the interest of the consuming public that prosecution of fraud in this area be hindered in any way. Our office has consistently taken the position that preemption of the powers of State authorities to prosecute fraudulent commodity operators is contrary to the public interest. The inability of the CFTC to cope alone with these fraudulent schemes lead to the amendments of the Commodities Exchange Act of 1978, which allow State regulators to proceed in the Federal courts to enforce the Federal statutes. This was a step in the right direction. However, we believe that all hindrances to State prosecutorial powers should be removed.

The millions of dollars lost by investors throughout the Nation require the fullest implementation of the enforcement powers of all agencies in all forums. The States do not wish to regulate the contract markets in commodities, nor do they wish to duplicate the activities of the CFTC. However, they do wish to exercise their powers over fraudulent activities unfettered by preemptive Federal legislation.

The necessity of going to Federal court, although not an insurmontable problem for our office, does create some problems for State regulators with more modest resources. State regulators are most familiar with their own laws, courts, and procedures. The present Federal court option requires the State regulator to enter into new and unfamiliar territory to combat these unscrupulous promoters. The natural tendency may be to resist the unfamiliar and consciously or unconsciously avoid any prosecution whatsoever.

This, of course, is an undesirable result for the investing public. In my view, State antifraud remedies can and should coexist alongside existing Federal remedies to combat commodity frauds and securities fraud.

The Commission's inability to give our office access to appropriate CFTC records is a matter that I am sure you gentlemen are familiar with. Your staff is also familiar with a number of actions we have commenced during the years immediately preceding 1981. I should point out, however, under the most recent amendment, our office did join with the CFTC in the case against Comercial Petrolera Internacional, and this cooperative action is a welcome change from the earlier CFTC policies.

For example, in 1976, the Commission appeared in New York State Supreme Court in the matter of *State* v. *J. S. Love* seeking to vacate an injunction obtained by our office on consent of the defendant permanently barring him from the securities and commodities business in New York State. The request of the CFTC to have this injunction vacated was unsuccessful.

In its eagerness to protect its own enforcement domain, the CFTC sought to vacate an injunction against a person who admittedly preyed upon the citizens of New York, as well as citizens located all over the United States.

I feel strongly that such a posture was ill-advised and contrary to the public interest.

Thus far in 1981, and thus far this year, under the mandate of the present attorney general of New York, Robert Abrams, we have proceeded criminally and in a vigorous manner against boilerrooms. And I think you gentlemen should be aware of how we are doing it in New York. We are not waiting for complaints to come in any longer, nor do we believe these boilerroom scoundrels are adequately deterred by civil injunctive relief. And I think that has been fortified by the testimony today of the two men who were previously in the commodities fraud business.

We now become aware of the existence of boilerrooms through intelligence information and proceed to try to infiltrate the operation by undercover operatives. When enough information is available for probable cause, an application for a search warrant is obtained from a judge and arrests are made and grand jury indictments obtained.

During the past 6 months, we have effected arrests of about 50 persons engaged in boilerroom activity. We have heard through the grapevine that our criminal prosecutions have had a chilling effect on this illegal activity. To put it in a nutshell, the boilerrooms are considering moving out of New York.

We are also seeking more effective laws in New York State to deal with this problem, including an increase in the penalty provisions of the present laws that deal with scheme to defraud and violations of the Martin Act.

A public hearing on boilerroom abuses will be held by our office at the World Trade Center next Thursday, March 4, to advance the possibility of getting additional legislation in New York.

An even greater chilling effect upon this activity nationwide would be for a signal to come out of this hearing and to be sent to the boilerroom operators that there is no longer any possibility of invoking the preemption of State activity as a defense to their criminal activity.

There is enough fraud out there to occupy prosecutors at all levels of government.

In conclusion, we welcome any statutory change, either on the Federal or State level, which would strengthen the ability of prosecutors to eliminate this very major problem. The boilerroom operators should know that the laws will be strengthened and adjusted so that the consuming public is protected. Hinderances to optimum protection should be eliminated once and for all. I invite whatever questions you gentlemen may have.

Chairman ROTH. Thank you, gentlemen. I share your concern that the Federal Government has preempted so much of the action. As you properly bring out, there is enough crime everywhere, and this is no place for turf battles.

One of the questions I would like to ask any one of you gentlemen, particularly you, Mr. Mihaly, is: You talk about this Commodity Club where everybody knows each other by name and reputation. We heard considerable discussion that these off-exchanged commodities are operated by a certain number of individuals who work for as many as 12 or more firms. Do you think, if we zero in on them, we could stop a lot of these crimes?

Mr. MIHALY. Of course. There is definitely a network or hardcore cadre of these operators. An illustration I can give you, Senator, one of our operatives managed to obtain a job in a particular boilerroom, worked there for a week or so—incidentally, without making any sales—and then went on to another boilerroom and used the first one as a reference. None of these boilerrooms he worked in, of course, bothered to take his home address or telephone number or anything like that, or obtain any standard type of information that would be required of a normal employer-employee relationship.

But the second boilerroom operator, knowing the man in the first boilerroom, called up and said, "Do you know this man?" "Yes, he worked here," and that is how he got his job in the second boilerroom.

I have no doubt there is a network of this hardcore cadre of boilerroom operators. They set up, as was testified this morning—when one boilerroom operator gets a good idea, he sets up a franchise operation all over the country, so-called wholesale operations, as evidenced by your chart here. There is a definite network of these people operating.

Chairman ROTH. If this is true, and it certainly seems to me that it is, why hasn't the CFTC approached it from this direction? Why have they been so ineffective?

Mr. MIHALY. Many things have been said here this morning about the ineffectiveness of the CFTC, the lack of manpower, the lack of funds. All of us suffer from that. I think it's a problem of really getting together with the States and eliminating this preemptive situation and working completely on a cooperative basis. As I stated in my statement, sending out a signal to these operators that there is not going to be anymore turf battles between the States and the Federal Government, and there is not going to be any turf battles between the States and other Federal agencies; that we are all united in going against these people wholeheartedly.

Mr. KREBS. If I may, Mr. Chairman, what we are talking about in each one of these instances are thieves. When you go after thieves with an injunctive process, you are using the wrong methods. We have available to us through State police, through our relationships with other investigators, district attorneys and their investigators, the capabilities Orestes has spoken about to infiltrate the boilerrooms.

CFTC doesn't have that. That is because their philosophy is a little bit slanted. In many instances, when someone lies to someone to get its money, a crime has been committed. That person ought to be tried in the jurisdiction where his victim resides, and that is the only way we can get effective, evenhanded justice here. The CFTC doesn't have the capability to introduce these agents in these boilerrooms. That is how you bust them up.

Chairman ROTH. Nor will it ever have the manpower or funds. Frankly, in Washington, that is the complaint of every agency. I don't care of what you speak. I agree with you and say as one Senator, I intend to do everything I can to insure the States do have the jurisdiction.

Mr. MIHALY. Let my add this, Senator, if I may. I think the CFTC and SEC. possibly one of their mandates from Congress may be to facilitate interstate commerce in the sale of commodities and securities. They have other goals. I would say the State administrators and the local police authorities have one goal, and that is for the investing public to be protected to the optimum.

Chairman ROTH. There has been a lot of talk about how you can start one of these operations with a little cash, a room, and a few phones. Is there any evidence organized crime elements are involved in this kind of an operation?

Mr. MIHALY. Let's say this: I have been with the attorney general's office for many years now, and I recall going back to the days of the classic security boilerrooms where organized crime, in the traditional sense, was definitely involved. We have heard rumblings of this also in this area, and we are looking into that situation.

Mr. KREBS. It is not unlikely they are, Senator. The risks are very few. It is very easy to do, and a great deal of money to me made. It has been our experience where those factors come to play, when they all coalesce, yes, you have organized criminals.

Chairman ROTH. Senator Rudman.

Senator. RUDMAN. Mr. Mihaly, one of the unique things about the attorney general's office in New York is that you have the criminal powers directly in your office. That is one of the reasons, of course, that you were able to move so very quickly based on your own investigation; is that correct?

[At this point, Senator Roth withdrew from the hearing room.]

[The letter of authority follows:]

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
Washington, D.C.

Pursuant to Rule 5 of the Rules of Procedure of the Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, permission is hereby granted for the Chairman, or any member of the Subcommittee as designated by the Chairman, to conduct open and/or executive hearings without a quorum of two members for the administration of oaths and taking testimony in connection with hearings on Commodity Fraud Investment Schemes, on Tuesday, February 23, Wednesday, February 24, and Thursday, February 25, 1982.

WILLIAM V. ROTH, Jr.,
Chairman.

SAM NUNN,
Ranking Minority Member.

Mr. MIHALY. Yes.

Senator RUDMAN [presiding]. It is also my understanding and knowledge, having been in this field one time myself, that the National Association of Attorneys General, and I also believe the Northern American Association of Securities Administrators, essentially have compacts within those organizations.

Mr. MIHALY. Absolutely.

Senator RUDMAN. Is that also correct?

Mr. MIHALY. That is correct, sir.

Senator RUDMAN. So you essentially have a cross-feed of information that goes between various State law enforcement organizations in which you alert each other about things that are going on throughout the country.

Mr. MIHALY. Yes.

Mr. KREBS. Not only that, Senator, from time to time, we perform specific investigations. We task organize ourselves to address a certain problem. The Leviticus Commodities organization is one of these. It involves the attorneys general from Kentucky, Virginia, and the Manhattan district attorney as well as the securities officials from Indiana, Alabama, and the other Appalachian States.

Senator RUDMAN. So if you have an insurance fraud scheme of which there have been some in the past few years that have been multi-State in nature, or you have a land selling scheme which was one of the great scams during the period 1970 to 1976, you put together task forces of your organization and State attorneys general, in larger States district attorneys, and you proceed to target these groups and to move with multi-State indictments against them; is that correct?

Mr. KREBS. That is correct.

Senator RUDMAN. But in this area, because of the preemption, your hands are tied.

Mr. KREBS. That is correct. I cannot employ a securities theory to stop theses boilerrooms.

Senator RUDMAN. You have a different problem than the attorney general in New York because he wears both hats in this particular——

Mr. KREBS. That is right. We have a very close working relationship with our district attorneys in the State and in the main, our efforts, thus far, on a multi-State level have been to support the jurisdiction wherein the boilerroom is located with testimony, documentary evidence.

Senator RUDMAN. Essentially, I think what you are telling the subcommittee and what you have told us in our meetings we have had with you, you say, fine, let the CFTC do the regulating at the area that they have many concerns in, and let them share the criminal area with you so that those who commit land fraud in the State of Alabama, Texas, New York, or insurance fraud and also commodity fraud, be treated alike; that there not be some niche that has been carved out that essentially benefits the criminal a great deal more than the victim.

Mr. KREBS. That is entirely correct, sir.

Senator RUDMAN. I have found very little disagreement with that attitude you have brought forth to us in the past 6 months.

I want to thank all of you for your testimony today, for the time that you have spent in advising our staff of your problems because I believe remedial legislation will be forthcoming.

Let me ask our staff director to ask several questions for the record. I want to thank you very much for your testimony today.

Mr. WEILAND. I have a couple quick questions. Mr. Latham, our investigation seems to indicate an increasing number of con artists are using the registration process at the CFTC to, in effect, assist them in their operation or to lend respectability to it. Can you comment on that and clarify whether that, in fact, is your own experience?

Mr. LATHAM. Yes, sir, it is a very common practice for the promoter in making his sales pitch to prospective investors to tout the fact that they are registered with the CFTC. It is one of their primary selling tools. Some regulatory agencies forbid the use of the fact of registration in advertisements.

I don't believe the CFTC does, and the promoters take full advantage of it largely because of the fact that with the massive number of persons they have seeking registration, it simply is not possible for them to do the kind of policing job that is necessary to deny registration to the bad guys.

Mr. WEILAND. One question for Mr. Krebs. The staff is also aware of the historical problem regarding the sale of options in the United States, a series of large-scale frauds that have arisen over the years with respect to options marketing.

Can you comment, Mr. Krebs, from your own experience, as to what you feel may develop with respect to the recent decision to begin marketing options again in the United States?

Mr. KREBS. Where is it going to stop? Where is there an economic benefit to this country? We have options on futures contracts, and now we are going to have futures on the stock index. We may as well start selling options on tulips or may as well start selling options on the mean temperature in the city of Los Angeles. It has got to have some relevance to our economy.

I have firms in Alabama now that are going bankrupt for want of capital. Why not try to encourage investment capital for these firms so we can put our people back to work instead of, in essence, institutionalizing a ponzi scheme or having national gambling contracts. If we are going to have a national lottery, let's call it that. That is, in essence, what these type contracts are.

Senator RUDMAN. Thank you very much. Appreciate it. Our last witnesses today are Michael Collora from Boston, Mass., former assistant U.S. attorney who has prosecuted two major commodity fraud swindlers, and Norris Penland who has been involved in boilerroom investigations in the State of Florida and is the postal inspector.

Gentlemen, it is a pleasure to have you here. It is the custom to swear witnesses before the subcommittee. If you will rise and raise your right hand.

Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. COLLORA. I do.

Mr. PENLAND. I do.

Senator **Rudman**. Thank you very much, gentlemen. Mr. Collora, if you would like to proceed.

TESTIMONY OF MICHAEL COLLORA, ESQ., FORMER ASSISTANT U.S. ATTORNEY, BOSTON, MASS.; AND NORRIS PENLAND, POSTAL INSPECTOR, MIAMI, FLA.

Mr. **Collora**. Thank you, Senator. I have prepared a statement which I have submitted to the staff, and I will ask it be accepted in the record in its entirety, and I will summarize it here.[1]

Senator **Rudman**. Without objection, that will appear in the record, and we would appreciate your synopsis of the statement.

Mr. **Collora**. As background, I prosecuted in Boston the Lloyd Carr case which was a London options fraud. Approximately $28 million was raised from the public by an escaped felon named Allen Abrahams who had been on the lam for about 3 years when he came to Boston and set up a company Lloyd Carr and Co.

He received a CFTC registration statement from the CFTC and began operations. They first became aware of him when he sued them 2 months later, along with British American. He never received an FCM, but continued to sell for another 13 months while the court case against him dragged on in Boston, New York, and Michigan.

During that period of time, virtually everyone who placed money with his company lost their entire investments because even if some money were due them, they were not paid. Our office came on to the scene some 12 months after the CFTC had been looking at this company, in response to the CFTC's request. We issued a search warrant within 15 days, prosecuted 12 defendants after indictments within 6 months and convicted all of them. Five went to jail.

That was in 1977–78. After the London options were banned, the boilerrooms changed and went into precious metals and into diamonds. Then they switched to oil and gas in 1979. As a result of a CFTC complaint, our office began investigating Bartex Petroleum, a company in Boston called Ramco and the supplier of oil called Comercial Petrolera Internacional. We assumed the entire investigation in the spring of 1980, and by November, we had indicted seven principals. They were tried in the spring of 1981, all pled guilty but one, he went to trial and was convicted. Everyone there went to jail.

I might point out to the Senator, in that case, no salesmen were indicted. In the Lloyd Carr case, about five salesmen were indicted. Our prosecutions became somewhat more sophisticated after we found that taking the time up in prosecuting salesmen simply was a waste of time. They drifted from company to company, were often employed for no longer than a month, and it was to the best interest of the public to go after the principals. So I would disagree with one of the previous witnesses, Mr. Levin, that we should prosecute the salesmen.

I think as far as criminal prosecution goes, the prosecution of the principals is probably the best use of limited resources available to the U.S. Attorney's Office and to the State Attorney General's Office. I would like, however, to point out some problems we ran into during the investigation.

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[1] See p. 212 for the prepared statement of Michael Collora.

One was that there appeared to be no registration process of any meaning for salesmen. Convicted felons using one name or another were in various sorts of companies. As that chart shows, they just drift from one to the other with immunity.

Second, they do use these minimal registration requirements of CTA and CPO which stand for Commodity Trading Adviser and Commodity Pool Operator in advertisements. I believe all it takes is $25 to get one of these by the person applying who perhaps shows no felony conviction. They then use these to raise millions of dollars from the public, and, very often, the public is left with nothing.

I am currently in private practice and am the receiver of two commodity pool operators where the principals are alleged to have churned approximately $6 million down to several hundred thousand in the period of time of several months. All the churning resulted solely in commissions to themselves, and they have disappeared. The money has disappeared and the investors have been unable to find out what has happened.

I might point out, one other problem we have with receiverships which the Senate will be hearing more evidence on later in the week, is that duties of the receiver are very vague. What rights do we have; in what court can we sue? Many of these issues have to be explored time and time again. It would help to have some statutory authority in that area.

In summary, I think it would have been helpful as a prosecutor and later on as a receiver to have more strict requirements for salesmen; to have capitalization requirements for anyone dealing in commodities, regardless of whether they are registered or not; to have bonding requirements so that there is someone left to pay in the event of a judgment much further down the line.

Although I have no particular criticism of the CFTC, it was my observations they were considerably overmanned, and I would welcome, I think, as a member of the public, seeing some involvement by the State regulatory authorities in this area.

Senator RUDMAN. Thank you very much. I am going to just, in the interest of time, ask you several questions at this point while your testimony is fresh in my mind.

Of course, your office did a remarkable job in handling that case. It was a landmark case. It was handled by the U.S. attorney's office in the city of Boston. I believe the U.S. attorney was Ted Harrington.

Mr. COLLORA. That is correct.

Senator RUDMAN. Mr. Harrington, of course, whom I have known personally many years, happened to be the head of the strike force for many years before becoming U.S. attorney. So you had a law enforcement organization that was really tuned to handle white collar fraud, am I correct?

Mr. COLLORA. That is correct.

Senator RUDMAN. And you undertook, once that case broke, essentially a major prosecution of that case. Mr. Harrington gave it the direction, used the FBI to the extent you had to; you had all the FBI help you required.

Mr. COLLORA. That's correct.

Senator RUDMAN. And yet the State of Massachusetts, the Commonwealth of Massachusetts, has a huge criminal prosecution apparatus. They, of course, essentially were barred.

Do you think it would have been helpful to you if the State had also been involved, not in a separate State prosecution, they were involved in a civil action, if the State had been involved essentially in helping the investigative process?

Mr. COLLORA. I have to put a caveat there. The State of Massachusetts, with which I am familiar, had enormous amount of difficulty in putting together large fraud cases. They don't have nationwide subpena power. They have difficulty in securing liason with foreign officials, unlike the FBI.

They don't have a lot of manpower or sophisticated investigators, such as the FBI does. So on the criminal side, I still think it is going to be mainly up to the U.S. attorney. On the civil side, however, when they can go in with injunctions and often can act quicker than the CFTC, I would welcome their involvement there.

So I guess I would break it up between criminal and civil. I think criminal is going to have to be left with the U.S. attorney's office for the most part, except in a large organization like New York City where U.S. attorneys do have large staffs for civil investigations, criminal investigations of that type.

Senator RUDMAN. You have many States where it is reversed, where the U.S. attorney is a small office and the State has a large investigative office.

Mr. COLLORA. Keep in mind many of these boilerrooms try not to sell in the State they are operating, thus the heat on them from State authorities is considerably less than it would be if they were selling to people in the area.

Senator RUDMAN. We appreciate your testimony very much because that is a case that certainly much can be learned from in terms of prosecution.

Mr. Penland, we will be pleased to receive your statement.

Mr. PENLAND. My name is Norris Penland. I am a postal inspector in Miami, Fla., where I have conducted mail fraud investigations for the past 12 years.

I would like to thank you for the opportunity to address this subcommittee and share my own ideas and findings in the field of commodity fraud as they are now and as they have been in the southern district of Florida for the past number of years.

Inflation, the entrance of precious metals into the American marketplace several years ago, and devaluation of American dollars made the bed in which the seeds of commodity investment frauds have been sown and were cultivated.

These conditions, coupled with the continuous population increase in south Florida and the resulting number of crooks who have also migrated to Florida has done much to enhance the conditions in which investment frauds have matured.

"Give me a telephone, an hour of product familiarization, and I will sell. If I can get the other person to listen to me, he is sold." That quotation was made or was said to me by a telephone salesman who has lived very well in south Florida for the past number of years selling everything under the Sun by telephone. He works 3 to 4 hours a day, 4 days a week.

During the 1960's and early 1970's, land was a big option. Advertisements were placed in newspapers. The public responded by mail, a brochure was mailed out describing in glowing terms the land that was being sold. A telephone followup was made within 10 days and the customer was then subjected to a hard sell.

During the midseventies, the big thing began with the sale of commodity options, especially London options. Those same salesmen who sold land and a whole new army of new recruits realized that the big money is not in the field of selling a tangible product but in the field of investments, particularly commodity investments.

With London options, the sales person had a built-in defense for any loss sustained by any customer. "We have no control over the foreign market" is the response that was given. As a result, the London option companies made only token investments or never made the investment at all, or to give the appearance of legitimacy, sent large amounts of money to banks in Europe to deposits of account with companies with impressive sounding names which were actually owned or controlled by the same persons who owned the Florida-based salesrooms.

In one instance, two men set up a salesroom to sell gold and other precious metals. The whole operation cost these men less than $3,000 to incorporate the company and to rent furniture and office space. An additional $1,500 to $2,000 was spent for a pair of WATS line telephones. One or two ads were placed in local newspapers advertising for telephone salesmen, and these two people were in business.

In about 3 months, they needed a European company to take the heat from complaints. They flew to the Island of Jersey in the Channel Islands where they formed three companies. A Jersey company would be the owner of record for the Florida company, a Luxembourg company to own the Jersey company, and then another Jersey company to be the consultant to the Luxembourg company. These two persons did not appear as owners of any of these three companies because everything was done through nominees. They were, however, hired by the end consulting company as advisers and consultants. Payment for their services was made by direct deposit to their personal bank accounts in Europe.

Five of their more aggressive salesmen were encouraged to and did open their own salesrooms and sold the paper of the first company. In about 11 months of active operation, the public was taken for almost $7,500,000.

This is one of the more complicated of the schemes. Many of the schemes are extremely simple. A company will be formed or, in some instances, only a name is used, sales are made and a company then closes up shop and moves away after 60 to 75 days.

One salesroom using the same salesmen and a variety of telephone numbers from the same business address has, over a period of 3 years, sold London commodity options, gold bullion, kruggerands, bag silver in thousand dollar units, silver by the kilo, diamonds, executive career management consultant services, oil and gas land lease lottery advisory services, shares in drilling ventures, and strategic metals.

Currently, commodity futures such as grains, coffee, and so forth, are not the real hot item in the investment fraud dealing in south Florida. The current item is anything relating to energy and/or strategic metals. There are, of course, some of the precious metal type schemes still going on.

Investment fraud schemes are so common in south Florida that some types of businesses and some business addresses are suspect with law enforcement simply because of the type of business or the address from which it operates.

Many known commodity investment schemes are designed to frighten the investor into an action that is not well thought out, and I quote several of these:

"The dollar is losing its value." "When your dollar is worthless, what do you do then?" "The economy is down, inflation has eaten away all of your normal hedges. Your only protection is an investment now in this program. If you delay, every day costs you money, as much as $100 for every $1 gold rises in price." "When you gamble the future, are you willing to gamble the future of your children?" "The United States gets 95 percent of its strategic metals from Communist or unstable countries. Why don't you cash in on this unstable situation?"

These are a few of the statements told to the potential victim, each of which is designed to erode and to destroy his faith in all legitimate investment programs. Newsclippings, quotes from economists and Government officials taken out of context are used to tout the advantages of the investment being offered, whether it be gold, silver, diamonds, oil or whatever. Law enforcement has been unable to keep up. The Postal Inspection Service, the Federal Bureau of Investigation, the Florida Department of Law Enforcement, and various county and city detective bureaus, the Securities and Exchange Commission and the Office of the Controller for the State of Florida are all involved in the investigation of commodity investment frauds in the Miami/Fort Lauderdale and West Palm Beach areas, as well as for the rest of the State.

Regularly we meet at the Federal Courthouse in Fort Lauderdale to share intelligence and to offer and receive assistance and ideas with each other. If a new scheme is uncovered or an investigation begun, all of us become quickly aware of it. As an example, a long time investment fraud con man was recently arrested in early February in Fort Lauderdale. By mid-February, he started a new company also dealing in investments.

My own estimate, and that of other investigators, is that there are now between 50 and 100 investment fraud schemes operating in south Florida. All are selling various investment programs. Primarily they are selling commodities such as strategic metals, shares of ownership in coal and mining ventures, oil and gas land lease lottery advisory services, precious metals, such as gold, platinum, and silver, shares of ownership in race horses, limited partnership in wells and fuel tanker ships. Some of the most successful of these are what we refer to in south Florida as the squeaky wheel operations. These relate to the sales of precious metals or other commodities and, of course, the public does not receive the product for which he is paying.

When he makes enough noise or threatens law suits or criminal complaints, he then, and only then, is furnished his commodity. Also, there is a strong rumor going around among the law enforcement agencies in south Florida that several of these companies may be selling counterfeit gold coins which are, in fact, lead, plated with gold. Because the sales force is just that, a sales force, it is extremely difficult or impossible to show that the salesman had guilty knowledge and the buyer of his product never does want to deface his new coins.

My own opinion, and I have expressed it many times to victims and con artists alike, there are no honest and legitimate commodity investment phonerooms anywhere. I believe any product which can be sold by a faceless voice on a telephone is available in better quality, at a lower cost in a location where the buyer meets the seller face to face. These investment commodity products can only be sold by misrepresentation of either or all of the product, service, or the price. The customer finds out only when he has lost his money.

Next to drugs, which has been estimated by the various Federal and State agencies to be a multibillion-dollar industry in south Florida, I believe white-collar crime, or more specifically commodity investment fraud, is probably the most lucrative industry. Money derived from the white-collar crime ventures has quickly spread into other areas such as drugs, into foreign markets out of the jurisdiction of the United States. Some of these are legitimate, but all of them enrich the schemers.

In almost every instance, these telephone salesmen and the mail fraud con artists constantly emphasize that this investment is a good tax shelter. "The loss is up to the Government, if you lose in this venture, you always have your tax writeoff."

In one specific instance, a company selling limited partnerships in oil drilling ventures collected $20,000 from each of a number of investors. The total amount they collected was approximately $1,500,000. They spent $400,000 drilling wells in Kentucky. Surprise of surprises, they struck oil. What did they do? They capped the well. The well produced only about 5 barrels a day, but the investors were told the well was producing at 200 barrels a day. Each investor was then sent a $600 "profit" and induced to agree to a reinvestment of all of future earnings of his drillings in new drillings, and the rest of the money was actually diverted to the perpetrators' personal use. The well is still not producing; it is still capped, but the strike is used in all of the sales pitches.

Unfortunately, because of the increase of other priorities, such as narcotics, illegal immigration, and violent crime, prosecution of white-collar crime has not kept pace. The mail fraud statute is one of the best vehicles for the prosecution of the white-collar crime con artists. Anonymity is essential to the success of the scheme. The provisions of title 18, United States code, "Section 1341 Mail Fraud," "Section 1342 Fictitious Names" and "1343, Wire Fraud" must be violated in any investment commodity fraud scheme.

In addition to the criminal investigations mentioned earlier, the regulatory agencies such as the Securities and Exchange Commission and the Commodity Futures Trading Commission are aware of these statutes and we regularly are advised and made aware of new companies whch may be in violation.

As always, the bottom line is what can we do about it, and what suggestions do we have? I have four suggestions.

I would like to see a directory of WATS line users be prepared annually and made available to law enforcement officers because most of these commodity investment frauds do use WATS lines, even for a short time. When a number is abandoned or relinquished that number should not be reassigned for at least 1 year or until the new directory is prepared.

Two, a civil remedy currently used by the Postal Inspection Service in medical fraud and other types of case, title 39, United States Code, section 3005, could be strengthened.

As members of this subcommittee are aware, Senators Pryor, Heinz, and Chiles have introduced Senate Resolution 1407 on June 22, 1981, for this purpose. The House version of this bill was introduced by Representative Claude Pepper, House Resolution 3973 on June 18, 1981.

Three, a special task force of prosecution attorneys should be assigned to the southern district of Florida to work with the existing agencies under the current law which I believe are adequate for the prosecution of white-collar crime.

And, fourth, I believe all investment commodity salesmen should be required to be registered with someone—the SEC, the CFTC—on an annual basis listing name, address, date of birth, and social security number; these cards to expire on the birth date of the registrant should be computerized and microfilmed for use only by regulatory or law enforcement agencies and the furnishing of false information should be made subject to the provision of title 18, United States Code 1001.

Senator, I thank you again for the opportunity to meet with you. Certainly, it is an honor I shall not forget.

Senator RUDMAN. Thank you very much, Mr. Penland. Two brief questions. I take it from your testimony there are a number of cases stacked up that, due to priorities, are not getting prosecuted; its that correct?

Mr. PENLAND. That is correct.

Senator RUDMAN. So there are cases there to prosecute, but the U.S. attorneys, particularly in south Florida, have many other priorities?

Mr. PENLAND. That is true, Senator. We have from our own agency approximately 20 some-odd cases that have gone unprosecuted for a period of approximately 2 years.

Senator RUDMAN. How do you feel, knowing the fairly substantial law enforcement apparatus, as well as the Attorney General's Office, how would you feel about them getting prosecutorial authority to prosecute some of these areas, particularly criminal prosecution?

Mr. PENLAND. Personally, I would be very much in favor of it. I would like any kind of prosecution done, something that can stop these people, put them out of business.

Senator RUDMAN. We want to thank both of you for appearing and for giving us your very excellent testimony. These hearings will continue for 2 additional days. Testimony will be from additional victims. We will be hearing from people appointed as receivers and see the problems they have experienced, and some other interesting testimony.

The Permanent Subcommittee on Investigations will now stand in recess until tomorrow morning at 9 o'clock in this room.

[Whereupon, at 1:15 p.m., the subcommittee was recessed to reconvene at 9 a.m., Wednesday, February 24, 1982.]

COMMODITY INVESTMENT FRAUD

WEDNESDAY, FEBRUARY 24, 1982

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met at 9:03 a.m., pursuant to recess, in room 3302, Dirksen Senate Office Building, under authority of Senate Resolution 361, dated March 5, 1980, Hon. Warren B. Rudman presiding.

Members of the subcommittee present: Warren B. Rudman, Republican, New Hampshire; and Sam Nunn, Democrat, Georgia.

Members of the professional staff present: S. Cass Weiland, chief counsel; Tom Karol, staff counsel; Eleanore J. Hill, chief counsel to the minority; Katherine Bidden, chief clerk; and Roy Geffen, staff investigator.

[Member present at convening of hearing: Senator Rudman.]

[The letter of authority follows:]

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Washington, D.C.

Pursuant to Rule 5 of the Rules of Procedure of the Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, permission is hereby granted for the Chairman, or any member of the Subcommittee as designated by the Chairman, to conduct open and/or executive hearings without a quorum of two members for the administration of oaths and taking testimony in connection with hearings on Commodity Fraud Investment Schemes, on Tuesday, February 23, Wednesday, February 24, and Thursday, February 25, 1982.

WILLIAM V. ROTH, Jr.,
Chairman.

SAM NUNN,
Ranking Minority Member.

Senator RUDMAN. This morning the Permanent Subcommittee on Investigations begins its second day of hearings on fraudulent commodity investments. Our emphasis today will be on customer recoveries in the wake of fraud schemes. We will begin looking at the registration process of the CFTC.

This morning we have several persons who are associated with the off-exchange commodity firms. I think it is extremely important for us to pursue this type of testimony if we are to have the background necessary to consider legislative change.

Our other witnesses include two commodity fraud victims, Curtis L. Washington and Richard J. MacMillan. Also, we have Eugene Fleming, court-appointed receiver for U.S. Investment Inc. and

Norwell Tradewinds, and Edward Dangel, court-appointed receiver for Bartex Petroleum, Henry Eschwege of GAO, Michael Unger, securities commissioner from Massachusetts, and K. Houston Matney, securities commissioner for Maryland.

Our first witness this morning is Mr. Robert Shoher who appears under subpena.

Mr. Shoher, will you please step forward and take a position at the witness table? It is customary to swear all witnesses before PSI. If you will please raise your right hand. Your name is Robert Shoher.

Mr. HECHT. And I am Charles Hecht. I represent him.

Senator RUDMAN. Raise your right hand. Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth and, nothing but the truth, so help you God?

Mr. SHOHER. I do.

Senator RUDMAN. You may be seated. I will ask our chief counsel, Mr. Weiland, to advise you of our procedure and your rights before the subcommittee.

Mr. WEILAND. Mr. Shoher, in the interest of making you fully aware of your obligations under the law to testify fully and truthfully at this hearing, I want to point out several matters to you.

First, I want to emphasize that the subcommittee has full legal authority to compel your testimony. Under rule 26, we have the right to subpena the testimony of witnesses. We also have the right under Senate resolution to require by subpena the testimony of witnesses before this subcommittee. You should be aware of the penalties for either refusing to testify or testifying falsely.

Under title 2, United States Code, section 192, for refusing to answer any question pertinent to the matter under inquiry, you could be prosecuted for contempt of Congress and punished by up to a year in prison.

Under title 18, United States Code, section 1621, and other statutes, you may similarly be prosecuted for perjury if you fail to testify truthfully.

I see that you are represented by counsel, and you may be assured that you are entitled to receive any and all legal advice that you require during the course of your testimony. I would ask that the counselor identify himself and the firm that he is associated with.

Mr. HECHT. Charles J. Hecht, P.C., by Charles J. Hecht, Suite 1760, 60 East 42d Street, New York, N.Y. 10165.

Mr. WEILAND. I also want to emphasize, Mr. Shoher, that you have the right not to incriminate yourself in any criminal matter by virtue of your testimony before this subcommittee.

Do you understand the rights and obligations that attach to your testimony this morning?

Mr. SHOHER. Yes, I do.

Senator RUDMAN. I wonder if you would take the microphone and place it close enough so we can hear you.

Mr. HECHT. Senator, one request under your procedural rules, and that is that I obtain on behalf of my client a copy of this transcript.

Mr. **Weiland**. We will certainly supply you with the transcript, Mr. Hecht.

Mr. **Hecht**. Thank you, Mr. Weiland.

Senator **Rudman**. Would you please state your full name and address for the record?

TESTIMONY OF ROBERT SHOHER; ACCOMPANIED BY CHARLES HECHT, ESQ.

Mr. **Shoher**. Robert Shoher, S-h-o-h-e-r. 4421 Northwest 73d Avenue, Lauderhill, Fla. 33319.

Senator **Rudman**. Mr. Shoher, have you ever been known by any other name?

Mr. **Shoher**. Yes, Mr. Chairman. I have used the name Bob Shore, without the exact pronounciation of my name. Also, on two or three occasions, I used a different name on the phone. I will try to think of names. It is about 3 years ago. I can't recall them right now.

Senator **Rudman**. I wonder if you would pull the microphone a little bit closer. You have a soft voice, and we want to make sure the stenographer hears you.

How long have you lived at your present address?

Mr. **Shoher**. Approximately a year and a half.

Senator **Rudman**. Where did you live prior to that?

Mr. **Shoher**. In Sunnyside, Fla.

Senator **Rudman**. And have you always been a resident of the State of Florida?

Mr. **Shoher**. For the last 8 years.

Senator **Rudman**. And before that?

Mr. **Shoher**. New York City, Long Island.

Senator **Rudman**. That has been the place of your residence for a great period of time before you came to Florida?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. State of New York?

Mr. **Shoher**. That is correct, sir.

Senator **Rudman**. Would you tell us, to the best of your recollection, how you have been employed over the last 1½ years?

Mr. **Shoher**. I have worked mostly in the commodity field as a salesman, as a manager or as an owner. Also, I have had a consulting company in the last year and a half.

Senator **Rudman**. Would you give us a list of names of the companies that have employed you over the last 5 years, companies that you have owned or participated in, to the best of your recollection?

[Witness conferring with counsel.]

Mr. **Shoher**. On advice of counsel, sir, I wish to state that it is my intention to cooperate with this subcommittee as fully as I possibly can. As the subcommittee is aware, I have previously had a discussion with Mr. Karol, staff counsel to the subcommittee, at which I indicated my intention to fully cooperate in your investigation.

Furthermore, I am or may be presently the subject of one or more criminal investigations and/or grand jury investigations relating to activities allegedly engaged in by myself. I hope that the subcommittee will respect my rights regarding these matters by not questioning me with respect thereto. Again, I wish to emphasize that I am happy to answer any questions the subcommittee may have which will not jeopardize my rights in these ongoing criminal matters.

Mr. **Hecht**. Maybe I could clarify that, Mr. Rudman. To the extent your questions are about specific companies, where, to his knowledge, there are no investigations, he would be permitted to answer. However, where there are, where there is knowledge that there are specific grand juries or criminal investigations, as to those areas, he is claiming his constitutional rights.

So if you will be specific, I think that will be of help.

Senator **Rudman**. Very well. Then we will go through a list with you, Mr. Shoher.

Mr. **Shoher**. Fine.

Senator **Rudman**. Did you work for Atlantic Coast Silver Exchange?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. American Currency Exchange?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. American Petroleum Exchange, Inc.?

Mr. **Shoher**. I request to take the fifth amendment on that one.

Senator **Rudman**. I would like you to clarify your answer; if you want to discuss it with your counsel. Do you tell me that you do not wish to advise this subcommittee whether you did or did not work for American Petroleum Exchange?

Mr. **Shoher**. I understand there is a grand jury investigation on that company right now, sir.

Senator **Rudman**. Well, I advise counsel of a statement to our staff members of January 12, 1982, in which your client stated that American Petroleum Exchange was one of the companies he worked for. I would now like to ask him, again, on the record, did you work for American Petroleum Exchange since you already told it to our staff investigators?

[Witness conferring with counsel.]

Mr. **Shoher**. Sir, I did not work for American Petroleum. I worked for a supplier of American Petroleum.

Senator **Rudman**. What was the name of that company?

Mr. **Shoher**. U.S. Petroleum.

Senator **Rudman**. You worked for Chartered Systems?

Mr. **Shoher**. Yes; I did.

Senator **Rudman**. Crown Colony Commodity Options?

Mr. **Shoher**. Yes; I did.

Senator **Rudman**. Dash Investments?

Mr. **Shoher**. Excuse me?

Senator **Rudman**. Dash Investments, D-a-s-h.

Mr. **Shoher**. No, sir.

Senator **Rudman**. How about EFCO Bank, E-F-C-O?

Mr. **Shoher**. No, sir.

Senator **Rudman**. Mr. Shoher, are you familiar with a case entitled *United States* v. *Alter* that was conducted in the southern district of New York in 1980?

Mr. SHOHER. *United States* v. *Alter* I am not familiar with. *United States* v. *Crown Colony Commodity Options, Alter-Steiner*—that I am familiar with.

Senator RUDMAN. Let me advise you, to refresh your own memory, that in testimony before you in the case of *United States* v. *Alter*, your name was connected with EFCO Bank. Are you now telling us that you were never employed by EFCO Bank?

Mr. SHOHER. I was never employed by EFCO Bank.

Senator RUDMAN. Were you associated with them in any way?

Mr. SHOHER. I know of EFCO Bank. I have had dealings with principals of EFCO Bank.

Senator RUDMAN. Did you ever engage in any common transactions with principals of EFCO Bank?

[Witness conferring with counsel.]

Mr. SHOHER. Yes, sir.

Senator RUDMAN. In other words, what you are saying is you engaged in transactions with them, but you were not employed by them?

Mr. SHOHER. That is correct.

Senator RUDMAN. That is your answer?

Mr. SHOHER. That is correct, sir.

Senator RUDMAN. First Regal Commodities Co.?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. How about International Metals Exchange?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. International Monetary Marketing, Inc.?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. London Commodity Options?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. New Era Oil Development?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. New Era Precious Metals?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Probber International Equities?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. R.T. & J. Trading Corp.?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Sabine Oil Exploration?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Williston Trading Corp.?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. And United States Petroleum Exchange?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Let me go through the list very quickly again, Mr. Shoher. You tell me whether or not you were a principal or employee. Atlantic Coast Silver?

Mr. SHOHER. Principal.

Senator RUDMAN. American Currency?

Mr. SHOHER. Principal.

Senator RUDMAN. American Petroleum Exchange?

Mr. HECHT. I think it has already been asked and answered.

Mr. SHOHER. I did not work for them, sir.

Senator RUDMAN. You worked for their supplier, which was United States Petroleum?

Mr. **Shoher**. That is correct, sir; an employee.

Senator **Rudman**. You worked as an employee of United States Petroleum?

Mr. **Shoher**. That is correct, sir.

Senator **Rudman**. Chartered Systems?

Mr. **Shoher**. Employee.

Senator **Rudman**. Crown Colony?

Mr. **Shoher**. Employee.

Senator **Rudman**. Dash?

Mr. **Shoher**. No connection, sir.

Senator **Rudman**. First Regal Commodities?

Mr. **Shoher**. Part owner for a short period to time.

Senator **Rudman**. And International Metals Exchange?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. International Monetary Marketing?

Mr. **Shoher**. Owner.

Senator **Rudman**. London Commodity Options?

Mr. **Shoher**. Employee.

Senator **Rudman**. New Era Oil?

Mr. **Shoher**. Part owner.

Senator **Rudman**. And New Era Precious Metals?

Mr. **Shoher**. Part owner.

Senator **Rudman**. Probber International Equities?

Mr. **Shoher**. Employee.

Senator **Rudman**. R.T. & J. Trading Corp.?

Mr. **Shoher**. Part owner.

Senator **Rudman**. Sabine Oil?

Mr. **Shoher**. Part owner.

Senator **Rudman**. Williston Trading?

Mr. **Shoher**. Employee.

Senator **Rudman**. And United States Petroleum Exchange?

Mr. **Shoher**. Employee.

Senator **Rudman**. Tell us about your connection with United States Petroleum.

[Witness conferring with counsel.]

Mr. **Shoher**. Based upon the advice of counsel, I respectfully decline to answer that question on the grounds that any answer would violate my privilege against self-incrimination as abiding with the fifth amendment of the U.S. Constitution.

Senator **Rudman**. Let me ask you some further questions of that and see whether or not your counsel feels you can answer them.

United States Petroleum was allegedly a supplier of oil for American Petroleum; is that correct?

[Witness conferring with counsel.]

Mr. **Hecht**. Could I have that question read back, please, Mr. Rudman?

Senator **Rudman**. Certainly. Would you read the question back for the witness?

[The pending question was read by the reporter.]

Mr. **Hecht**. Mr. Rudman, I believe that has been asked and answered.

Senator **Rudman**. Well, I would like it answered again.

Mr. **Shoher**. Yes, sir.

Senator RUDMAN. Did United States Petroleum own any oil wells?

Mr. SHOHER. Sorry, sir?

Senator RUDMAN. Did it own any oil wells?

Mr. SHOHER. No, it did not, sir.

Senator RUDMAN. Did it own any oil?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. In what form?

Mr. SHOHER. Contractual commitment for oil, sir.

Senator RUDMAN. With what companies?

Mr. SHOHER. Through the oil exchange to a company called Petrigas to the Venezuelan Government.

Senator RUDMAN. Did it ever supply, to your knowledge, any oil to American Petroleum Exchange?

Mr. SHOHER. Did who, sir?

Senator RUDMAN. United States Petroleum.

Mr. SHOHER. United States Petroleum was never required to deliver physical oil to American Petroleum Exchange.

Senator RUDMAN. Did it ever deliver contracts for the right to purchase oil to American Petroleum?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. To your knowledge, how much volume of business did United States Petroleum do during the time you were associated with it?

Mr. SHOHER. I would rather not guess, sir.

Senator RUDMAN. How long a period were you associated with United States Petroleum?

Mr. SHOHER. Approximately 6 months, sir.

Senator RUDMAN. Mr. Shoher, we went over a list of companies that you were either associated with as an employee or as an owner. To the best of your knowledge, sir, which of these firms or the principals of these firms, including yourself, have been the subjects of any criminal action by the U.S. Government or any State?

Mr. SHOHER. Could you please list them again one by one, sir?

Senator RUDMAN. Atlantic Coast Silver?

Mr. SHOHER. Not to my knowledge.

Senator RUDMAN. American Currency Exchange?

Mr. SHOHER. Not to my knowledge.

Senator RUDMAN. American Petroleum Exchange or United States Petroleum?

[Witnesses conferring with counsel.]

Mr. SHOHER. They are under investigation, sir. There has been no action.

Senator RUDMAN. Chartered Systems?

Mr. SHOHER. Not to my knowledge, sir.

Senator RUDMAN. Crown Colony Commodity Options?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. What was the action against them?

Mr. SHOHER. There was a CFTC action, I believe, for injunctive rights to stop them from functioning, and then there was a trial held in Florida approximately 2 years ago against the principals of Crown Colony Commodity Options.

Senator RUDMAN. Who were those principals?

Mr. SHOHER. Joel Steiner and Joe Alter.

Senator RUDMAN. And were they convicted?

Mr. SHOHER. I believe they were, sir; yes, sir.

Senator RUDMAN. But you were not involved personally in that prosecution?

Mr. SHOHER. In the prosecution, I was a witness of the Government.

Senator RUDMAN. But you were not a defendant in that case?

Mr. SHOHER. No, I was not.

Senator RUDMAN. First Regal Commodities?

Mr. SHOHER. I do not know of any actions against them.

Senator RUDMAN. International Metals Exchange?

Mr. SHOHER. I do not know of any action against them.

Senator RUDMAN. International Monetary Market?

Mr. SHOHER. No action against them.

Senator RUDMAN. London Commodity Options?

Mr. SHOHER. I do not know.

Senator RUDMAN. New Era Oil Development?

Mr. SHOHER. Do not know, sir—I am sorry.

[Witnesses conferring with counsel.]

Mr. SHOHER. I believe there is an ongoing inquiry. I don't know what type of inquiry it is.

Senator RUDMAN. New Era Precious Metals?

Mr. SHOHER. Yes, sir, there was an action against New Era Precious Metals. I went to the assistant U.S. attorney in the southern district of New York and said I felt I committed a fraud in reference to New Era Precious Metals, and on investigation, I pled guilty of committing fraud.

Senator RUDMAN. When you say you went to them voluntarily, there had been no investigation prior to you going voluntarily?

Mr. SHOHER. There had been no ongoing investigation; no, sir.

Senator RUDMAN. You just on your own decided to go up and say you committed fraud?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Have you ever done that before?

Mr. SHOHER. No, sir.

Senator RUDMAN. Probber International Equities?

Mr. SHOHER. No known investigation, sir.

Senator RUDMAN. R.T. & J. Trading Corp.?

Mr. SHOHER. No known investigation; no investigation, sir, that I know of.

Senator RUDMAN. Sabine Oil Exploration?

Mr. SHOHER. No investigation.

Senator RUDMAN. Williston Trading Corp.?

Mr. SHOHER. No, sir.

Senator RUDMAN. We already discussed United States Petroleum. You testified in the Crown Colony case?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Wasn't there a case involving New Era Metals?

Mr. SHOHER. New Era Precious Metals.

Senator RUDMAN. All right.

Mr. SHOHER. Sir, that is the case I said that I pleaded guilty.

Senator RUDMAN. And you were convicted in that case?

Mr. SHOHER. Yes, sir.

Senator **Rudman**. What was the sentence?

Mr. **Shoher**. 3 years; 2½ years suspended; served 6 months.

Senator **Rudman**. Where did you serve that 6 months?

Mr. **Shoher**. At FCC. That is Florida Correctional Center; [MCC] Metropolitan Correctional Center and I was in a halfway house, Phoenix-Oxford Halfway House run by the Government, in Manhattan.

Senator **Rudman**. Were you also fined any amount of money?

Mr. **Shoher**. $1,000.

Senator **Rudman**. How about International Metals Exchange, you were given immunity in that case; is that correct?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. Have you been involved in any prosecutions other than these as a defendant?

Mr. **Shoher**. No, sir.

Senator **Rudman**. The only conviction against you involves the New Era Metals case?

Mr. **Shoher**. That is correct, sir.

Senator **Rudman**. What do you do for a living now?

Mr. **Shoher**. Basically a consultant. I am trying to sell art.

Senator **Rudman**. What, sir?

Mr. **Shoher**. Art work, sir; lithographs.

Senator **Rudman**. For whom?

Mr. **Shoher**. I am an independent contractor.

Senator **Rudman**. Where do you engage in that occupation?

Mr. **Shoher**. Mostly in Florida, sir.

Senator **Rudman**. Do you have a place of business?

Mr. **Shoher**. I usually use my home.

Senator **Rudman**. How are you compensated presently for the work that you do?

Mr. **Shoher**. We haven't sold anything yet, sir. I haven't gotten anything organized yet.

Senator **Rudman**. How have you supported yourself the last several years?

Mr. **Shoher**. By doing various sundry things.

Senator **Rudman**. Such as?

Mr. **Shoher**. Consulting work.

Senator **Rudman**. What type of consulting work?

Mr. **Shoher**. Excuse me, also I had a telephone salesman who was selling chemicals over the telephone.

Senator **Rudman**. For whom? Who were you selling chemicals for?

Mr. **Shoher**. For myself, sir.

Senator **Rudman**. I know, but what companies were you representing?

Mr. **Shoher**. Ourselves. We were repackaging chemicals.

Senator **Rudman**. What kind of chemicals?

Mr. **Shoher**. All-purpose cleaners.

Senator **Rudman**. To whom were you selling these all-purpose cleaners?

Mr. **Shoher**. Gas stations, garages, restaurants, motels, hotels, anybody who could use an all-purpose cleaner.

Senator **Rudman**. What is the last time that you were involved in any type of commodity sales?

Mr. HECHT. Maybe, Mr. Rudman, it would help if you defined what you mean by "commodities." Commodity futures or off-exchange commodities? You could consider the chemicals a commodity. If you could define "commodity," maybe that would help.

Senator RUDMAN. Fine. Let's go through the whole list. Prior to your selling these cleaners, what was your prior employment before that?

[Witness conferring with counsel.]

Mr. SHOHER. United States Petroleum.

Senator RUDMAN. So what year was that?

[Witness conferring with counsel.]

Mr. SHOHER. I think it was 1979 to early 1980 range, sir.

Senator RUDMAN. What was the date of your conviction in New Era?

[Witness conferring with counsel.]

Mr. SHOHER. Sir, are you saying when I went?

Senator RUDMAN. When did you serve time?

Mr. SHOHER. From December of 1980 until April of 1981.

Senator RUDMAN. You were released from the halfway house in April of 1981?

Mr. SHOHER. I believe it was April 24, sir.

Senator RUDMAN. What was your employment immediately thereafter?

[Witness conferring with counsel.]

Mr. SHOHER. Immediately when I got out of jail, sir, I had no job.

Senator RUDMAN. Well, what was the first job you had when you got out of jail?

Mr. SHOHER. I had a company called SRS Marketing. I was a consultant to telephone sales organizations.

Senator RUDMAN. What were you selling?

Mr. SHOHER. Mostly lists, reports.

Senator RUDMAN. Lists and reports that have to do with what?

Mr. SHOHER. I am sorry, phone lead lists. Lists of qualified customers.

Senator RUDMAN. Qualified to buy what?

Mr. SHOHER. Anything, sir.

Senator RUDMAN. Commodities?

[Witness conferring with counsel.]

Senator RUDMAN. Commodity options?

Mr. SHOHER. No commodity options, sir.

Senator RUDMAN. Who did you sell the lists to?

[Witness conferring with counsel.]

Senator RUDMAN. Mr. Shoher, that is a fairly simple question. I don't think it requires a great deal of legal consultation. I simply asked you who you sold the lists to?

Mr. SHOHER. Highfield of America.

Senator RUDMAN. What do they do?

Mr. SHOHER. They sell strategic metals.

Senator RUDMAN. So actually shortly after getting out of the halfway house, you were selling lists to people who engaged in the selling of commodity options for strategic metals?

Mr. SHOHER. Sir, I don't know what they were selling.

Senator RUDMAN. You don't know what they were selling?

Mr. SHOHER. No, sir.

Senator RUDMAN. No idea at all?

Mr. SHOHER. I know they were selling strategic metals; that is all I know.

Senator RUDMAN. That is the only person you sold the lists to?

Mr. SHOHER. I had one or two small firms.

Senator RUDMAN. What were their businesses?

Mr. SHOHER. Chemical business, sir.

Senator RUDMAN. Would that be an unfair characterization of those sales to say that you were selling these lists essentially to other boilerroom operations in the State of Florida?

Mr. SHOHER. Will you define what "boilerroom" means, sir?

Senator RUDMAN. I think you can probably define that better than I can.

[Witness conferring with counsel.]

Mr. SHOHER. Sir, I don't know how the chemical company I sold to, I don't know how they operated; I don't know how Highfield of America operated.

Senator RUDMAN. You have no idea?

Mr. SHOHER. No, sir.

Senator RUDMAN. Mr. Shoher, the name, again, of the company you sold your lists to, the strategic metals firm?

Mr. SHOHER. Highfield of America.

Senator RUDMAN. Do you know the principals in that firm?

Mr. SHOHER. I know people in the firm. I don't know if they are principals, sir.

Senator RUDMAN. What are their names?

Mr. SHOHER. Mr. Davis and Mr. Niewald.

Senator RUDMAN. How long have you known them?

Mr. SHOHER. Three, four years.

Senator RUDMAN. Have you had other business transactions with them or in their behalf or they on your behalf?

[Witness conferring with counsel.]

Mr. SHOHER. Yes, sir.

Senator RUDMAN. What kind of transactions?

Mr. SHOHER. I had a relationship with Mr. Davis in a company called Sabine Oil.

Senator RUDMAN. What oil?

Mr. SHOHER. Sabine Oil.

Senator RUDMAN. What did Sabine Oil do?

Mr. SHOHER. Nothing, sir.

Senator RUDMAN. What did they do?

Mr. SHOHER. Nothing, sir.

Senator RUDMAN. What did they do?

Mr. SHOHER. They were going to develop oil wells, do oil drilling, but they never did anything.

Senator RUDMAN. Were they ever engaged in the sale of options or futures on oil?

Mr. SHOHER. No, sir.

Senator RUDMAN. Any other relations with Mr. Davis?

[Witness conferring with counsel.]

Mr. SHOHER. I sold lists to Highfield of America.

Senator RUDMAN. But other than that, there has been no prior relationship whatsoever?

[Witness conferring with counsel.]

Mr. **Shoher**. I don't believe so.

Senator **Rudman**. You, of course, have given us a list here today in response to our questions of a great number of companies that you worked for. Would many of those be characterized as boilerroom operations in the parlance of the trade?

Mr. **Shoher**. Yes, sir.

Senator **Rudman**. Are you going to tell this subcommittee this morning that you are unaware of the fact that Mr. Davis is well known for his connection with boilerroom operations in Florida? Are you going——

Mr. **Shoher** [interposing]. Sir, what does "well-known" mean?

Senator **Rudman**. Pardon?

Mr. **Shoher**. What does "well-known" mean?

Senator **Rudman**. Is it known to you, Mr. Shoher?

Mr. **Shoher**. What?

Senator **Rudman**. That he is involved with boilerroom operations and has been for many years.

[Witness conferring with counsel.]

Mr. **Shoher**. I know he has been involved in telephone sales for a number of years; yes, sir.

Senator **Rudman**. So essentially when you sold those lists to him, you had a pretty good idea it would be used for that type of operation?

Mr. **Shoher**. I did, sir; yes.

Senator **Rudman**. Let's at least get that clear on the record. And how long after you were released from the halfway house did you sell these lists to him?

Mr. **Shoher**. Approximately 2 months later.

Senator **Rudman**. Two months later. When you were interviewed by our staff investigators, you were indicating you were or had been, not in recent times, an undisclosed principal in a firm. Which firm was that?

Mr. **Shoher**. If I told the staff something, can they please refresh my memory?

Senator **Rudman**. They asked you what the firm was and, at the time, you would not answer the question, but when they asked you what you were doing, you said, among other things, you were an undisclosed principal in a firm, and that was contained in your interview of January 12, 1982.

Now, are you presently an undisclosed principal in any firm of any type, either unincorporated or partnership?

Mr. **Shoher**. Perhaps what the investigators were talking about is the chemical company I had. My son was the general manager and he ran the whole company. It was my company, but he put himself forward as being the principal of the company to all the employees, all the vendors, and all the suppliers.

Senator **Rudman**. But you were the principal?

Mr. **Shoher**. I owned the company; yes, sir.

Senator **Rudman**. Was there any reason that you decided to be an undisclosed principal in that particular firm?

Mr. **Shoher**. I wanted him to run the firm, sir.

Senator **Rudman**. Were you advised by counsel to be an undisclosed principal in that firm?

Mr. SHOHER. No, sir, and I think the terminology "undisclosed principal" is pushing the point. When anybody came up to the office to be employed, my son interviewed them; he hired them; he fired them; he paid them. He ran the company, and that is why I wanted him to operate the company.

Senator RUDMAN. Mr. Shoher, there are a whole number of companies here you answered as owner or partner in response to my questions earlier. Were most of these companies incorporated?

Mr. SHOHER. I do believe so, sir; yes.

Senator RUDMAN. Who did the legal work to set up those companies?

Mr. SHOHER. Do you want to go over the list, sir?

Senator RUDMAN. Pardon?

Mr. SHOHER. Do you want to go over the list?

Senator RUDMAN. Certainly. Atlantic Coast Silver?

Mr. SHOHER. I did not.

Senator RUDMAN. American Currency?

Mr. SHOHER. My partner and I set up that corporation; yes, sir.

Senator RUDMAN. Did you have a lawyer?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Who was your lawyer at the time?

[Witness conferring with counsel.]

Mr. SHOHER. I am sorry, sir, I don't know. It was a law firm in New York.

Senator RUDMAN. Let me ask you this question rather than going through the whole list. Have you used particular counsel quite often in setting up these various corporations and partnerships that you have been involved in?

Mr. SHOHER. Most of the corporations and partnerships I have been involved in, sir, I have not set up. They have all been done by my other partner or the people I worked for.

Senator RUDMAN. So your answer to the question is that you have not used any lawyer or law firm in particular to set up all of these companies that you have been a owner or part owner?

Mr. SHOHER. That is correct, sir.

Senator RUDMAN. Mr. Hecht has represented you before?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. In the setting up of companies?

Mr. SHOHER. No, sir.

Senator RUDMAN. In what regard has Mr. Hecht represented you before?

Mr. SHOHER. In the criminal case I had with New Era, Mr. Hecht went forward with me.

Senator RUDMAN. In New York?

Mr. SHOHER. When we first approached the Assistant Attorney.

Senator RUDMAN. Has Mr. Hecht been a principal with you in any of your companies or strictly a lawyer?

Mr. SHOHER. Strictly a lawyer, sir.

Senator RUDMAN. Tell us about the offshore companies that you have been involved with, Venezuelan companies, Bahamian companies, or any other offshore companies you have been involved with.

Mr. SHOHER. The only company I worked for was United States Petroleum in the Bahamas. I was the manager for a while before I was replaced by a Bahamian manager.

Senator Rudman. In your dealings with companies that you were either a principal in or a part owner in, did you have extensive dealings with any offshore companies marketing their products or having them help you market yours?

Mr. Shoher. To the best of my knowledge, no, sir.

Senator Rudman. Mr. Shoher——

Mr. Hecht [interposing]. Could you hold for a second?

Senator Rudman. Yes, certainly.

[Witness conferring with counsel.]

Mr. Shoher. Sir, correction. There was a group of Dutch investors that put up money into Sabine Oil to drill oil wells. The oil wells were drilled thereafter. So if you consider that to be a foreign company, yes.

Senator Rudman. You said the wells were drilled thereafter?

Mr. Shoher. Yes, sir.

Senator Rudman. I believe, if my recollection is correct, that about 20 minutes ago, discussing that company, that you indicated they never really did anything; they were set up but they never did anything. Did you say that?

Mr. Shoher. Yes, sir. That was a private investor. I believe at that time you were talking about selling things to the public. If so, I misunderstood your question. Sabine did drill and operated some oil wells in Louisiana in Avoyelles Parish, drilled wells and operated them, but they never took money from what I call the investing public in the United States. It was a Dutch group that brought in *x* amount of dollars into a specific series of wells.

Senator Rudman. How much money did they bring into that company? What was the capitalization of that company?

Mr. Shoher. It was supposed to be $520,000. I believe they came in with $300,000.

Senator Rudman. Did the investors ever receive any of their funds back?

Mr. Shoher. I do not know, sir.

Senator Rudman. Were you a principal in that firm?

Mr. Shoher. In Sabine, yes, sir.

Senator Rudman. Did you make an investment in that firm?

Mr. Shoher. No, sir; just time and effort.

Senator Rudman. Say again?

Mr. Shoher. In Sabine Oil, all I invested was my time and my best efforts.

Senator Rudman. Mr. Shoher, we have gone over quite a list here of companies you worked for over a period of several years. Is that a 5-year period?

Mr. Shoher. Approximately 5 years, yes.

Senator Rudman. 1975——

Mr. Shoher [interposing]. Starting in August of 1976, I went to work for Crown Colony Commodity Options in Miami.

Senator Rudman. That was the first such job that you had?

Mr. Shoher. Yes, sir.

Senator Rudman. And for the 3 years thereafter, you were involved with a whole list of companies that we have already discussed here this morning?

Mr. Shoher. Yes, sir.

Senator RUDMAN. Would you say most of those companies operated on the thin edge of legality?

Mr. SHOHER. I can't answer that, sir. I think they operated legally.

Senator RUDMAN. You think they operated legally.

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Were they what we generally call boilerroom operations, in the parlance of the trade?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Tell us the kind of income you derived over these years from these companies?

[Witness conferring with counsel.]

Senator RUDMAN. I don't mean individually, I mean in aggregate.

Mr. SHOHER. In the 5 years, I would say approximately—I don't have my tax returns with me—but about——

[Witness conferring with counsel.]

Mr. SHOHER. Approximately $150,000 in 5 years, sir.

Senator RUDMAN. $350,000?

Mr. SHOHER. No; no, $150,000.

Senator RUDMAN. $150,000 in 5 years.

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Which of the companies that you owned either wholly or partially was the most successful of all those companies?

Mr. SHOHER. I don't know what you mean by "most successful," sir.

Senator RUDMAN. Did the greatest amount of sales volume.

Mr. SHOHER. Crown Colony, the first company I worked for, I would believe did the largest volume.

Senator RUDMAN. How much volume would that have been, do you know?

Mr. SHOHER. I think they were doing upward of $1 million a month.

Senator RUDMAN. And how much of that were you doing?

Mr. SHOHER. I made with Crown Colony in 6 months, I believe $9,000.

Senator RUDMAN. Mr. Shoher, we went through a list of companies that you state that you worked for. Were there other companies in addition to that list that you either worked for or consulted for as an owner or partial owner?

Mr. SHOHER. I would imagine that list is about 95 percent complete.

Senator RUDMAN. Did you think of any significant omissions from that list?

Mr. SHOHER. I had a small vending machine company in 1976. I might have done some odd jobs for people.

Senator RUDMAN. Mr. Shoher, what I would like you to do now is describe for us how you set up any one of these companies that was engaged in the selling of commodity options, contracts and so forth. I would like you to just describe how much capital it took, how you went about it, how you set one of these companies up.

[Witness conferring with counsel.]

Mr. SHOHER. I never set up a company that dealt with commodity options.

Senator RUDMAN. What were they dealing with?

Mr. SHOHER. Leverage accounts, forward accounts. Let me say this, sir——

Senator RUDMAN. Which of the leverage account companies that you set up was the most successful in terms of sales volume?

[Witness conferring with counsel.]

Mr. SHOHER. I was involved in the formation of a company called First Regal.

Senator RUDMAN. First what?

Mr. SHOHER. First Regal.

Senator RUDMAN. And when was that set up?

Mr. SHOHER. I believe they received their Commodity Futures Trading Commission license or approval, their FCM, April 1, 1977.

Senator RUDMAN. We have that list, and it is one of the companies you discussed, Tell us about how you set that up, how much money it cost. Just give us a picture, if you will, of what it took to get into that business and how you operated?

Mr. SHOHER. I can give you very limited information on that. I was a 20-percent partner. There were two other partners who each had 40 percent in that business. They supplied all the funds and all the capital. I believe there was a $50,000 requirement for capitalization. One of the two partners put that up. The rent for the office was put up by one of the two partners, other than myself. And I was acting in the guise, in the aspect of sales manager hiring, training people, being sales manager for which I got 20 percent of the company. And I was also later elected president of the company for approximately 3 weeks.

The details of how the company was set up, I can't tell you. I do know that we dealt with Shearson Hayden Stone to buy options, mostly on sugar from Shearson Hayden Stone. That was one of my functions.

At the end of every day, as funds cleared through our bank account from clients, I would call Shearson Hayden's Miami office and place orders for three sugar options, four sugar options, whatever the day's volume might be. The booker would assign the purchase order numbers from Shearson Hayden, line entries, all of the clients whose money cleared. I kept the ledgers for that company.

Senator RUDMAN. How were solicitations made in this particular company?

Mr. SHOHER. By telephone, sir.

Senator RUDMAN. From lists?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Where did you get the lists?

Mr. SHOHER. Purchase them from list brokers.

Senator RUDMAN. And how long were you with that company?

Mr. SHOHER. Approximately 3 months, sir.

Senator RUDMAN. Three months. Why did you leave?

Mr. SHOHER. We had a dispute among partners. I being the smallest of the three partners was thrown out of the firm, discharged.

Senator RUDMAN. Was that company registered?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. And who were the partners in that company; who were the other principals?

Mr. SHOHER. Steve Sawyer and Ronny Pardis.

Senator **Rudman**. Are you still acquainted with those gentlemen?

Mr. **Shoher**. I saw Mr. Pardis about 6 months ago, and I haven't seen Mr. Sawyer in approximately 2 years.

Senator **Rudman**. Do you know what Mr. Sawyer is doing today?

Mr. **Shoher**. No, sir, I don't.

Senator **Rudman**. No idea of what his employment is?

Mr. **Shoher**. No, sir.

Senator **Rudman**. How about the other gentleman?

Mr. **Shoher**. Yes, he owns a telephone relay service in Florida.

Senator **Rudman**. How many of these companies that you worked for went out of business while you were working for them?

Mr. **Shoher**. I can't answer that, sir.

Senator **Rudman**. Well, name some of them that did, or we can go through the list, if you like.

Mr. **Shoher**. Would you, please.

Senator **Rudman**. How about Atlantic Coast Silver Exchange?

Mr. **Shoher**. I resigned from the company. I resigned all position in the company, but it was still in business when I resigned.

Senator **Rudman**. How much later after that did they go out of business?

Mr. **Shoher**. I don't know, sir.

Senator **Rudman**. They did go out of business.

Mr. **Shoher**. I think so.

Senator **Rudman**. How about American Currency?

Mr. **Shoher**. American Currency ceased operations by turning over their books, records and all pertinent data to another corporation to continue their operation. They did continue thereafter quite a while.

Senator **Rudman**. How about Chartered Systems?

Mr. **Shoher**. I think they are still in business, sir.

Senator **Rudman**. Crown Colony?

Mr. **Shoher**. They were stopped from doing business approximately 6 months after I left the firm, sir.

Senator **Rudman**. How about First Regal?

Mr. **Shoher**. When I left, it was still in business.

Senator **Rudman**. International Metals and International Monetary Marketing, Inc.?

Mr. **Shoher**. International Metals Exchange, sir?

Senator **Rudman**. That's correct.

Mr. **Shoher**. I was with that company at the close.

Senator **Rudman**. Why did they close?

Mr. **Shoher**. There was a lack of money to keep going.

Senator **Rudman**. Did some of the customers lose money in that transaction?

Mr. **Shoher**. Most of the customers, yes, sir.

Senator **Rudman**. And how much did they lose?

Mr. **Shoher**. I don't know specifically. It was a lot of money.

Senator **Rudman**. London Commodity?

Mr. **Shoher**. When I left, they were still in business.

Senator **Rudman**. New Era Oil?

Mr. **Shoher**. I left; they were still in business. I resigned from that corporation.

Senator **Rudman**. Did they go out of business shortly thereafter?

Mr. SHOHER. I really couldn't answer, sir. I think they might still be in business.

Senator RUDMAN. How about New Era Precious Metals?

Mr. SHOHER. I was with that company at the close.

Senator RUDMAN. Again, did a great many people lose money in that transaction?

Mr. SHOHER. New Era was only dealing with wholesalers. New Era—the wholesalers—I do not imagine caused failure to the individuals.

Senator RUDMAN. Any idea how much?

[Witness conferring with counsel.]

Mr. SHOHER. Yes, sir, I worked up a chart of all the people who lost money. I believe it was about, between $100,000 and $150,000 was lost.

Senator RUDMAN. Probber International Equities?

Mr. SHOHER. They were in business when I left.

Senator RUDMAN. Did they go out of business thereafter?

Mr. SHOHER. I think so, sir; yes. Yes, definitely.

Senator RUDMAN. Pardon?

Mr. SHOHER. Probber International Equities definitely went out of business.

Senator RUDMAN. And Mr. Probber was convicted, is that not correct?

Mr. SHOHER. To the best of my knowledge, no, sir.

Senator RUDMAN. And Williston Trading Corp.?

Mr. SHOHER. I left and they were still in business.

Senator RUDMAN. Did they subsequently go out of business?

Mr. SHOHER. I imagine so.

Senator RUDMAN. Mr. Shoher, is it not true that in most of these operations, or certainly in a number of them, that you were associated with, when sales volume was slow, money that normally would go to cover customer contracts was used to pay the overhead expenses of the company; money was diverted from the customer accounts?

Mr. SHOHER. I can testify, sir, to New Era Precious Metals and IME. That was the case in those two companies, yes, sir. That is when I went to the assistant U.S. attorney and pled guilty to fraud.

Senator RUDMAN. So essentially what starts out, in many cases, as apparently a legitimate operation, as soon as there is a need for funds for internal expenses, it turns illegitimate?

Mr. SHOHER. In the two firms I was connected with in that respect, sir, yes, that was the story.

Senator RUDMAN. Mr. Shoher, are you telling us this morning that your current income will be derived solely from being involved in the art business?

Mr. SHOHER. At the current time, yes, sir. Excuse me, let me stand corrected. Approximately 1 week ago, I started another company that is trying to sell video games.

Senator RUDMAN. What is the name of that company?

Mr. SHOHER. VES Marketing.

Senator RUDMAN. Is that incorporated?

Mr. SHOHER. Yes, sir, State of Florida, about 10 days ago, 15 days ago.

Senator RUDMAN. Are you a principal in that?

Mr. SHOHER. Yes, sir.

Senator RUDMAN. How much capital does that company have?

Mr. SHOHER. So far, approximately $1,000.

Senator RUDMAN. Now you are trying to sell artwork and video games. I am just curious, where do you get your product?

Mr. SHOHER. The video games can be bought from anybody. There are approximately 50 manufacturers in the United States, plus there are overseas manufacturers and there are distributors all over the State of Florida where we can purchase them. The business is only, as I said, approximately 15 days old. We have made no sales yet. The same with the artwork, I made no sales.

Senator RUDMAN. Is this going to be a telephone operation also?

Mr. SHOHER. The video game?

Senator RUDMAN. Yes.

Mr. SHOHER. Mostly in-house.

Senator RUDMAN. The artwork?

Mr. SHOHER. Mostly in-house.

Senator RUDMAN. Are you currently involved in anyway as a consultant to firms dealing with commodity options, commodity contracts, leverage contracts or any of those arrangements that typify your past employment?

[Witness conferring with counsel.]

Mr. HECHT. Mr. Rudman, there is a problem. I believe commodity options were outlawed as of June 30, 1978.

Senator RUDMAN. That is right. We have had a number of witnesses here that were involved in activities against the law for some time. So I am going to repeat the question.

Are you involved in any of those activities?

Mr. SHOHER. No, I am not, sir.

Senator RUDMAN. Are you consulting in any way to any organization that is involved in the sale of options or any form of commodity instruments?

Mr. SHOHER. Currently, no, sir.

Senator RUDMAN. Have you had discussions that would lead to such employment in the past 90 days?

[Witness conferring with counsel.]

Mr. HECHT. Could you, Mr. Rudman—how do you define the term "commodity"? Commodity options I believe you said. How do you define commodities? Is it commodity futures, what is normally regulated by the CFTC which they have litigated over, that kind of thing?

Senator RUDMAN. I think Mr. Shoher knows precisely what I am talking about. I won't repeat the question. I will ask Mr. Shoher whether or not he is dealing, attempting to deal, having discussions leading to future dealings in any business that is related in anyway to those that he was involved in, multitudes of businesses he was involved in in the last 5 years. Now, that is my question.

Mr. SHOHER. In the last 90 days, sir?

Senator RUDMAN. That is correct.

Mr. SHOHER. The answer is "No."

Senator RUDMAN. The answer is "No." While you were incarcerated, did you have discussions with people by telephone or in person that would lead to employment of that type?

Mr. SHOHER. No, sir.

Senator RUDMAN. Mr. Shoher, were you not consulting for a company in the last 60 days that had its telephone service completely disconnected, cut off?

Mr. SHOHER. To my knowledge, no, sir.

Senator RUDMAN. Your answer is "No."?

Mr. SHOHER. To my knowledge, no, sir.

Senator RUDMAN. Mr. Shoher, the CFTC has recently issued some pilot programs to allow options trading. Are you aware of those new regulations?

Mr. SHOHER. No, I am not, sir.

Senator RUDMAN. You are not aware of them at all?

Mr. SHOHER. No, I am not.

Senator RUDMAN. You didn't discuss those with our investigators?

Mr. SHOHER. If so, very briefly, sir, without going into details.

Senator RUDMAN. What is your view of the enforcement procedures brought by CFTC against companies such as the ones that you were working with?

Mr. SHOHER. As I told your investigators, I though the CFTC was very negligent.

Senator RUDMAN. Very negligent in what way?

Mr. SHOHER. That they didn't do proper enforcement. These are my opinions from my limited knowledge, not going in depth in any company. Just from my general observations what I read in the newspapers, what I hear in the grapevine that they have not been effective, not like the SEC.

Senator RUDMAN. Just a few more questions. What is the value of the home you live in in Florida?

Mr. SHOHER. I haven't had it appraised. I bought it for $118,000 with a first and second mortgage of—the first and second mortgage was approximately $100,000.

Senator RUDMAN. Tell us your current net worth.

Mr. SHOHER. Including gifts from families, sir?

Senator RUDMAN. Including everthing.

Mr. SHOHER. Approximately $150,000.

Senator RUDMAN. Are you currently on probation?

Mr. SHOHER. Yes, I am, sir.

Senator RUDMAN. For what period of time?

Mr. SHOHER. 2½ years from April 24, sir.

Senator RUDMAN. Mr. Shoher, finally, are there any special terms and conditions on your probation that deal with your business activities?

Mr. SHOHER. Not to engage in unlawful businesses.

Senator RUDMAN. That is part of your probation.

Mr. SHOHER. Yes, sir.

Senator RUDMAN. Does it deal in particular with some of the businesses that you were involved in in the past?

Mr. SHOHER. I don't have a copy of that. I do not think so. I could stand corrected if I read it, though, sir.

Senator RUDMAN. Mr. Shoher, we will supply your counsel with a copy of the transcript this morning. We will review it, and we may have further questions for you at a subsequent date. Thank you very much.

Mr. SHOHER. Thank you, sir.

Senator RUDMAN. The next witness is Raymond Day.

Mr. Day, will you raise your right hand, please?

Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. DAY. I do.

Senator RUDMAN. Would you state your name and address?

Mr. DAY. My name is Raymond Day. I am presently serving a Federal prison sentence resulting from a conviction for running a commodities boilerroom operation.

Senator RUDMAN. Do you have a statement that you would like to read into the record?

Mr. DAY. Yes, sir.

Senator RUDMAN. Would you proceed with the statement, Mr. Day?

TESTIMONY OF RAYMOND DAY, COMMODITY FRAUD DEFENDANT

Mr. DAY. I pled guilty in June 1980 in that case of 12 counts of mail and wire fraud and one count of illegally selling options.

I began my commodities career in October 1976 when I began selling options for a company called Bristol Options. Prior to that time, I had been a telephone salesman for seven or more companies selling electronics and chemicals.

From October 1976 to August 1978, I worked as a telephone salesman for several commodity houses, including Bristol Options, Williston Trading Corp., Herbert Young Commodities, which was a subsidiary of Chartered Systems, Inc., and Fairchild Arabatzis Smith.

Bristol, Williston Corp., and Fairchild have since been shut down for trading fraud.

During this time, I witnessed extremely high-pressured sales techniques, unethical individuals, and customers who lost all of their investments. When I first started working for these companies, I did not believe that these companies were defrauding the customers. However, by the time I left them, I felt sure that they were.

I incorporated my own New York company which I named Archaray Enterprises in November 1977. The company was not active as a commodity house until August 1978. I utilized my past experience with other companies to create an operation which would sell investment contracts. At that time, I began selling gold, silver, and oil on a deferred delivery contract basis. These contracts were later held by the CFTC to be illegal commodity options.

I began Archaray with three phones and around $900 in capital. I slowly built up the business, adding salesmen as I grew. By the time my doors were closed, I had about 50 salesmen who had brought in over $2.5 million by selling contracts to over 270 customers.

I made up a script for my salesmen as some of them were inexperienced in selling options. Many salesmen, however, were past associates from other commodity sales operations in which I had worked. I also made up instructions on how to close a sale.

Most salesmen eventually made up their own scripts after a little experience. The sales force was eventually managed by two supervisors and I also contracted with another individual for him to market Archaray contracts under a so-called Euro-American Currencies.

We sold by making initial phone calls to prospective customers, and these calls were followed up by sending a brochure out. We then followed up with another high-pressure call designed to make the customer excited about the investment. The salesman would read the customer our contract over the phone and answer any questions about it. To close, we would get the customer's bank account number and tell the customer to stand by his phone. We would immediately call the bank that he did business with and tell them to wire transfer the appropriate funds to Archarays New York account after he got the permission from the customer.

The bank would then call the customer and the funds would be transferred.

Archaray initially covered sales by buying contracts from London Swiss Commodities. However, London Swiss defaulted in March 1979 and we immediately lost over $150,000. From that point on, we began to Ponzi our new contracts in order to pay off early contracts. To keep my people happy, to keep my clients happy, we returned over $462,000 to my early customers in this fashion. The rest of the $2.5 million was eaten up by expenses and profits.

The FBI raided Archaray in September of 1979, and the CFTC filed a civil suit. We consented to a civil judgment. The FBI estimated that had Archaray actually bought the contracts it promised, those contracts would be worth over $19 million.

My experience is an example of how easy it is to open and operate a boilerroom operation. And my knowledge of commodities was gained only after 2 years. Yet with $900, I brought in $2.5 million in 1 year.

Senator RUDMAN. What was the initial rate you paid your salesmen, Mr. Day?

Mr. DAY. Forty percent on all sales.

Senator RUDMAN. Forty percent?

Mr. DAY. Yes, sir.

Senator RUDMAN. You stated in your statement a few moments ago that you made up a script for your salesmen?

Mr. DAY. Yes, sir.

Senator RUDMAN. I assume these were lists you——

Mr. DAY. The lists that I used were brought from list houses and I would give them to the salesmen as they would need them. They would come to me and say they need leads and I would give it to them.

Senator RUDMAN. Could you describe the sales pitch, the script you made up for your people?

Mr. DAY. It was a one-page pitch. It went something like this: "Good morning, Mr. Jones, my name is Raymond Day from Archaray Enterprises in New York. Have you seen what the gold is doing lately?" He would say, "No, I haven't paid any attention to it at all." "Well, in the past few days or weeks, gold has"—done such and such and he would tell them what it has been doing.

"Right now Archaray is offering to the public contracts on a deferred delivery basis, 3-, 6-, and 12-month periods. I would like to send my information to you in the mail, and once you get it, I would like you to read it over carefully and I will have one of my salesmen call you back next week and discuss it further with you," and that would be the initial sales call.

Senator RUDMAN. And at the height of your business, how much volume were you doing?

Mr. DAY. About $200,000 a week.

Senator RUDMAN. And you set this up with about $900 in capital?

Mr. DAY. Yes, sir.

Senator RUDMAN. How long did you operate this particular company?

Mr. DAY. Approximately 1 year, from August of 1978 to September 14, 1979.

Senator RUDMAN. I am just curious as to what happened that caused the Federal authorities to move in on you. What was the source of the complaint?

Mr. DAY. Well, I had one client in Chicago, Richard Archer, who had sent in $26,000. Gold was in a profit position and his contracts—he had a profit over and above the $26,000, something like $14,000. So I wrote him a check for $40,000.

I sent him a check for the $40,000 and on the day he got the check for $40,000, I had a check that was sent to me from another client that bounced in my bank. The balance of my bank at the time was only $76,000 So that made the check I sent Mr. Archer for $40,000 bounce. He came up to my office, he'd seen me in a T-shirt and dungarees. Of course, he was shocked. I told him I could not pay him. I showed him the check. I told him that I would be able to make it up to him in about 2 weeks. Two weeks went by, I couldn't send him the check but I called him up and I told him I could send him one check for $15,000 and when that cleared, I could send him another check for $15,000 and then when that one cleared, I would send him a check for $10,000.

I sent him the first check for $15,000, it cleared and 2 weeks later, the FBI came in and raided my office and took all of my records.

Senator RUDMAN. So actually the cause of your demise was not what you were doing in the commodity business, it really had to do with a bounced check?

Mr. DAY. Yes, sir.

Senator RUDMAN. Do you know a gentleman named Wilburt Wilson who was a fugitive in a New York case?

Mr. DAY. I know him from a company called Fairchild Arabatzis & Smith. We used to work there.

Senator RUDMAN. What did he do before he went into the commodity business?

Mr. DAY. He had a few chicken franchises in Brooklyn. In other words, he had fast food restaurants.

Senator RUDMAN. And did he open a business similar to yours?

Mr. DAY. He registered with the CFTC as a commodity pool operator and he opened a commodity pool business.

Senator RUDMAN. Was it successful for a while?

Mr. DAY. I guess it was. He took in $7 million, sir.

Senator **Rudman**. $7 million?

Mr. **Day**. Yes.

Senator **Rudman**. He is now a fugitive?

Mr. **Day**. Yes, sir.

Senator **Rudman**. Mr. Day, there is a pilot program that is, I believe, going on at this time that would allow certain options to be sold on legitimate futures. What effect do you think that will have on illegitimate operators?

Mr. **Day**. It will be a field day for illegitimate operators. First, the public will know that it is legal to trade options, so when they get a call from an illegal operator, they will think they are legal initially. It doesn't matter how much they pay for the option for even if the option is stated in a newspaper $3,000 here and you are going to charge the guy $7,000.

It doesn't matter. What it will do, in effect, is make it easier for the illegitimate operator to sell that person.

Senator **Rudman**. So I guess your conclusion is in terms of protecting the consuming public, it is not a very good idea.

Mr. **Day**. Not at this time, sir, unless there is legislation to regulate it differently than it is being regulated now.

Senator **Rudman**. What did you do before you entered the commodity business?

Mr. **Day**. I was a night manager for a chemical sales organization.

Senator **Rudman**. Chemical sales?

Mr. **Day**. Yes, sir.

Senator **Rudman**. Was that a legitimate operation?

Mr. **Day**. As far as I know, sir, yes.

Senator **Rudman**. Thank you very much, Mr. Day. I appreciate your testimony.

Our next witnesses will be Bobby Howell and Dan Sledd. If the two witnesses will raise their right hands.

Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Howell**. I do.

Mr. **Sledd**. I do.

Senator **Rudman**. You may be seated.

Mr. **Kadish**. If I could have 30 seconds of your time.

Senator **Rudman**. Counsel, proceed

Mr. **Kadish**. My name is Marc K-a-d-i-s-h. I am assistant professor of clinical education at Chicago-Kent College of Law in Chicago, Ill. I was court-appointed for Mr. Howell in the criminal trial which led to his conviction. Mr. Howell, and Mr. Sledd and myself feel that we can be of the most assistance to the subcommittee in their investigation with the Cayman Islands connection; that is, the ease with which money is moved from the United States and invested in the Caymans with the assistance of Cayman Islands attorneys.

As a matter of fact, the location of Jefferson National Investment Corp. in Tampa Bay/Clearwater, Fla., was because of the fact that there was a direct flight from Tampa Bay to the Cayman Islands. We would, therefore, welcome any questions by yourself, sir, after Mr. Howell's statement with reference to the Cayman Islands connection.

Senator RUDMAN. Thank you very much, Mr. Kadish, and we appreciate your cooperation. Mr. Howell, you have a statement.[1]

TESTIMONY OF BOBBY HOWELL AND DAN SLEDD, COMMODITY FRAUD DEFENDANTS PANEL

Mr. HOWELL. Yes, sir.

I first became involved in commodity sales in January of 1977. For the 7 years prior to that, I had successfully sold life insurance and real estate. The real estate firm I was working with went out of business in January of 1977 and I started selling London options with a firm known as Franklin Commodities in Atlanta.

While with Franklin Commodities, I applied for and obtained an associated person's license from the CFTC in the early summer of 1977, I and three other people formed a commodity firm known as Lincoln Federal Investment Corp. We obtained a futures commission merchant license from the CFTC for this firm in July of 1977.

And at that time, sir, of the four people that comprised this corporation, I was the only one that had any commodity experience at all, and that was very limited, only 2 to 3 months had I been in the commodities market. The other three people barely knew what a commodity was at the time we were registered.

Lincoln Federal was immediately successful and generated significant cash flow for us. However, in October of 1977, the firm had to comply with the CFTC's double segregation requirement wherein 90 percent of our customer's premium funds had to be segregated in an escrow account. We managed to circumvent this requirement by having our customers sign a waiver form wherein they waived this requirement with respect to their personal account.

Senator RUDMAN. I wonder if you would move that microphone a little bit closer so our stenographer can hear you well.

Mr. HOWELL. Lincoln Federal operated from the spring of 1977 to the spring of 1978. During that period, we sold over $2 million in contracts to between 300 and 400 customers.

To cover its sales, Lincoln Federal bought options from a firm known as Commodity Analysis, Ltd., a British company with the New York office. We charged our customers at least twice the cost of the options to us. We had 15 salesmen situated in a plush office and obtained our leads from industrial directories. Many of our calls were cold calls out of that directory and many were quite successful. We told the salesmen to avoid calling attorneys because we had some problems when they lost money filing lawsuits against us. So we just avoided calling them.

During the spring of 1978, an auditor from the CFTC looked at our books and later we were charged with keeping inadequate records and for failing to segregate 90 percent of the customer's funds. As a result of this investigation, Lincoln Federal voluntarily ceased business under a CFTC consent degree in May of 1978. We were put into receivership.

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[1] See p. 217 for the prepared statement of Bobby Howell.

In any event, the selling of options was banned by the CFTC in the summer of 1978.

Shortly after that, in the summer of 1978, Dan Sledd and I incorporated First United Investment Corp. and we began selling investment quality diamonds. About 2 or 3 months after this initially started, we were informed of a new vehicle for selling commodities known as deferred delivery contracts. We made some inquiries into this type of transaction, and we started selling deferred delivery contracts through First United.

We got a corporation in the Cayman Islands known as Swiss International Depositor where we could hedge our contracts in gold and silver. The idea was to get around the option ban by having Swiss International cover overseas with options. By late September 1978, we had raised over $230,000 from 40 customers using 8 to 9 salesmen. First United sold a locked-in price contract for gold and silver to be delivered in from 92 to 180 days. The contract price was nonrefundable and included storage, insurance, interest, and commissions, and there were no margin calls. Our agreement with our customers was that delivery could not take place before the contract expiration date, and we assured customers that we would offset their contracts before delivery to enable them to realize profits if the market went up.

The whole deferred delivery concept was designed to take advantage of the fact that those contracts are not supposed to be regulated. Apparently, some salesmen were telling investors that the metals they purchased were held in a vault in the Bank of Nova Scotia in Grand Cayman and they would get a certificate of ownership from the bank which would identify the lot of metal they owned. This was pure fabrication as the Bank of Nova Scotia handles all of its gold and silver storage out of its Toronto offices and handles only cash purchases and only issues certificate for paid contracts.

We wired the proceeds from our First United operation to our bank account in the Cayman Islands and traveled down and carried cash back and forth and also wired funds to the Chase Manhattan Bank from the Cayman Islands to pay customers back.

After internal conflicts developed, Bobby Sledd and I closed down our First United operation and moved to Clearwater, Fla., where we set up Jefferson National Investment Corp. We chose Clearwater because it has one of the direct flights to the Grand Cayman Island, one of the few direct flights. Also, the customs going in and out of Clearwater/St. Pete Airport was a lot less rigid than the Miami Customs. It was just beneficial for us to travel in and out through there with sums of money.

The company was opened in October of 1978. It was next door to the FBI's resident office in Clearwater. We rented the office suits on the 11th floor of one of the high rises in Clearwater. Of course, the FBI was right there. We wound up having office suites on both sides of them, and even the salesmen a lot of times in their sales presentation would tell people we have the FBI surrounded because we were on both sides of them and they were in the middle of us, which didn't turn out to be so.

As long as we operated our Clearwater boilerroom, we never had any trouble with our FBI neighbors. Jefferson National held itself out as selling actual metal when, in fact, we were only selling options. We set up a new Cayman company known as European International Depository Ltd. Salesmen held out European International as being a very old, reputable, solvent precious metals depository in Geneva, Switzerland.

We told people Jefferson National was European International Depository's sole distributor in the United States and told people that European International held all its physical metal sold by our company.

From December of 1978 through September 1979, Jefferson National sold approximately $1.3 million worth of contracts to 156 investors in 26 States. When we finally closed our doors in November of 1979, we paid back $365,000 to about 50 customers.

In the financial summary, 1.3 million for Jefferson National—to break this down somewhat—checks to myself for $45,319; checks to Mr. Sledd, $39,213; personal expenses of ours were $101,450; checks paid to cash which went to the Cayman Islands and then back for our own personal use, something like that, was $200,109; deposits to Caymans Bank, $71,400 [sic].

It was a total withdrawal for personal use of $457,572. We returned to customers $364,218. Legal fees to receiver, $35,710, and other expenditures, such as overhead, commissions, sales, so forth, $460,000, which came to $1.3 million. That is all I have, sir.

Senator Rudman. Mr. Howell, there are some aspects of your testimony we would like to go over in some detail. We are going to hear testimony regarding registration with the CFTC. You stated you actually obtained registration as a futures commission merchant.

Would you elaborate on that process?

I thought that license took a fair amount of capital.

Mr. Howell. At that point in time, it took $50,000 capital. There were four of us involved in the corporation. Two gentlemen put up the $50,000. We made formal application on whatever the form numbers are through the Commodity Futures Trading Commission. We put the $50,000 in the account. I think we had to verify with a deposit slip, something. It was not too much. We could have left the money in there overnight and withdrawn it the next day.

We were a month to 45 days later approved. It was a very simple ordeal getting that license.

Senator Rudman. To your knowledge, were there any background checks on any of the people?

Mr. Howell. I assume there was, but I don't know for sure. At that point in time, the four of us who were involved had no problems whatsoever.

Senator Rudman. We have heard a fair amount of testimony from you this morning about your use of offshore banks, and this subcommittee is looking into that whole problem because it is a problem that goes far beyond the kind of dealings you are talking about here this morning.

What attracted you there and what about U.S. laws legal restrictions, if any?

Mr. Howell. I guess the main attraction was the secrecy laws of the Cayman Islands. They are very rigid in banking. As far as circumventing U.S. laws—the Government, attorneys over there know what you are doing and are still willing to work with you and provide you banking services, attorney services, everything, in order to accomplish your mission.

It was just a very compatable situation because our main effort was to try to stay in the commodity business and to circumvent the option ban which was in the spring or summer of 1978.

Senator RUDMAN. Did you have attorneys representing you in the Caymans?

Mr. HOWELL. Yes.

Senator RUDMAN. Were they aware of the kind of operation that you were setting up?

Mr. HOWELL. Definitely.

Senator RUDMAN. They were?

Mr. HOWELL. Yes.

Senator RUDMAN. Did they tell you how to do it?

Mr. HOWELL. They told me how to do it. As a matter of fact, what we were to do, we were going to sell the deferred delivery or physical contracts—they have several different names—here in the States to U.S. investors.

The attorneys in the Caymans were well aware all they were to do was to buy an option to support the sales we had made in the States.

Now, during the last phase of our business, we didn't cover them because the market outran it, but we did buy a lot of options through that Cayman corporation at one time to hedge our position over here with our customers.

Senator RUDMAN. Were the attorneys who represented you in the Caymans aware of the fact this really was not a legitimate operation you were running?

Mr. HOWELL. They led us to believe they didn't think that it was not legitimate, they felt as long as we were covering or hedging every position then it was legal because the corporation in the Cayman Islands could legally sell naked options or hedge it any way they wanted to.

So they led me to believe if I sold over here, as long as I gave them an order, it was covered in the Caymans, then everything was all right. That didn't happen.

Senator RUDMAN. Did you believe that everything was all right?

Mr. HOWELL. On the front end, I did, but later on, it got out of hand, way out.

Senator RUDMAN. Mr. Sledd, tell us what your involvement was with this operation in terms of setting up the arrangements in the Caymans.

Mr. SLEDD. It was a mutual—the setting up of the operation was mutual. Bobby and I went to the Caymans many times. We found out prior to going down from some Atlanta attorneys and businessmen who had previously used a very similar operation—in fact, we ended up purchasing an operation that was already in existence down there in the Caymans.

The Atlanta attorneys had written legal documents that said if you do it this way, you should stay in the realm of the law.

If you don't believe us, go down and talk with these Cayman attorneys, which we did. As Bobby mentioned, on the front end, everything looked A to Z like it should. But later on, it was just like a wind tunnel. We were in the middle of it and couldn't slow it down.

Senator RUDMAN. Were there any U.S. currency laws that slowed you down at all?

Mr. SLEDD. Oh, no. In fact, many times we wired—one time we wired $159,000 down, 50,000, 70,000.

None of the banks ever had us sign any type of requisition saying, you know, you wired over "*x*" amount of dollars, or we have forwarded someone, the IRS, someone about this. Never anything like that. It was very, very simple. In fact, I believe that is one of the major problems. Our Governement is too concerned with a small amount of money coming back in, $5,000 that are on the forms when you come in when it should be just the opposite, I think.

[At this point, Senator Nunn entered the hearing room.]

Senator RUDMAN. You would have been unable to continue this operation as you continued it if, in fact, there were any kind of oversight on large amounts of money being transferred to these Cayman banks?

Mr. SLEDD. Absolutely.

Senator RUDMAN. In fact, even if it were legitimate but the reporting requirements were stringent, certainly it would have come to somebody's attention fairly early on if there was something unusual going on here.

Mr. SLEDD. Correct.

Senator RUDMAN. But to your knowledge, that was never done?

Mr. SLEDD. Absolutely not.

Mr. KADISH. Senator, may I briefly add, I think one of the problems is that such large amounts of money move into the Cayman Islands that the people in the Cayman Islands themselves are very used to suitcases full of millions of dollars, so it means absolutely nothing to them.

With reference to the secrecy laws of the Cayman Islands, there came a time in the criminal case where Mr. Howell and Mr. Sledd, in order to satisfy the sentencing judge, had to try to provide themselves the records from the Cayman banks in order to verify they did not have any money left over, that they, after serving a sentence, would not have a nest egg in the Cayman Islands.

We served subpenas, wrote letters, made telephone calls and Mr. Sledd himself was forced to personally go down to the Cayman Islands in order to get all the records.

When all the records came down, and Mr. Sledd himself, who was one of the signatories of the bank account who met with his own attorney, when he returned with the records from the Cayman Islands, they were misleading, incomplete and incorrect because we had stipulated at the criminal trial that there were a number of wire transfers that had gone in and out of the Cayman Islands which were never even listed on the records we received. And we have supplied those records to the subcommittee.

With reference to the attorneys from the Cayman Islands, this is something I, myself, have gotten interested in, and we have cooperated with the U.S. attorney in Chicago, that the names of several Cayman attorneys have come up again and again in terms of boilerroom investigations here in this country with reference to offshore money.

And, in fact, there was a fairly famous burglary in Chicago involving $3.3 million from Purolator, and organized crime was allegedly involved in that.

The attorney that washed that money in the Grand Cayman Islands is the same attorney that was involved in this instance here.

Senator RUDMAN. And that name has been supplied to our staff.

Mr. SLEDD. Yes.

Senator RUDMAN. Did you finally end up, Mr. Sledd, with any money at all, or did you lose everything?

Mr. SLEDD. No, sir, I don't have any money at all. We lost everything.

Senator RUDMAN. How long was your sentence?

Mr. SLEDD. At first, Senator, it was for 12 years. It was later reduced to 4 years.

Senator RUDMAN. You have served how long now?

Mr. SLEDD. Since November.

Senator RUDMAN. Where are you serving?

Mr. SLEDD. Well, we started in Springfield, Mo. We were later transferred to a Federal camp in El Reno, Okla. However, I think we are being transported now to an alien detention center in Cedar Hill, Tex.

Senator RUDMAN. And you, however, have continued to cooperate fully——

Mr. SLEDD. Absolutely.

Senator RUDMAN [continuing]. With prosecutors and with this subcommittee.

Mr. SLEDD. Absolutely, sir, and will continue to do so. We are scheduled to appear and help on some other things.

Senator RUDMAN. Mr. Howell, what laws could have existed that didn't exist that would have prevented your ability to defraud as many people as you defrauded, as far as the CFTC is concerned?

Mr. HOWELL. Well, if they had a closer hand on new corporations springing up like this—it seems to take a year or so for them to get around to finding out something is going on. I think if on a State level, I guess that is as far down as you can go, I think it can be monitored a lot closer. When a corporation is set up you have certain key signs. If they want a telex machine, a Reuter's machine, if they want any of these commodity-checking devices, then the company should red flag the company name and send it to one of the agencies. Obviously, they are going to go into the commodity business somewhat.

Senator RUDMAN. Actually, you and Mr. Sledd and your associates were totally incompetent to run this business, by your own testimony. You did not have professional training.

Mr. HOWELL. We were good salesmen. It was a product, we knew a little bit about it and we could sell it. That is how we started.

Senator RUDMAN. It is probably harder to get a license to cut hair in the State of Florida.

Senator Nunn, do you have any questions for these witnesses?

Senator NUNN. No.

Senator RUDMAN. Thank you very much for your cooperation. We will continue to make inquiries if they are necessary. We particularly want to thank your court-appointed counsel, Mr. Kadish, for being so cooperative.

Mr. Fleming and Mr. Dangel, will you come forward, please. Please raise your right hand.

Do you swear the testimony you will give in the course of this hearing will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. FLEMING. I do.

Mr. DANGEL. I do.

Senator RUDMAN. Before we get your statements, on behalf of the subcommittee, we want to thank you very much for all the time you have spent talking to our staff and for taking time in your own schedules to come to Washington today. I particularly want to say hello to Mr. Fleming who is a friend of some standing.

Both of you gentlemen have been involved as receivers in trying to straighten out some of the situations that arose in the Commonwealth of Massachusetts with some of the more famous cases and I wonder if you individually have statements, summaries of your statements or how would you like to proceed, Mr. Dangel.

RECEIVER PANEL

TESTIMONY OF EUGENE FLEMING, ATTORNEY (COURT-APPOINTED RECEIVER FOR U.S. INVESTMENT, INC. & NORWELL TRADEWINDS); AND EDWARD DANGEL, ATTORNEY (COURT-APPOINTED RECEIVER FOR CPI & BARTEX PETROLEUM)

Mr. DANGEL. Senator, I would like to submit the written testimony that was previously prepared for the subcommittee as a written statement. I have prepared other remarks for you this morning.[1]

Senator RUDMAN. If you would like to proceed with those remarks, we would appreciate it.

Mr. DANGEL. Thank you.

My name is Edward Dangel. I am a lawyer in Boston, Mass., and I am here as the receiver of a group of companies which are under the umbrella known as CPI. I was appointed by a judge in the southern district of New York as receiver for all of these companies. The companies are in Massachusetts, New York, Panama, and in various States around the country.

Basically, my duties as a receiver, is to collect back money for defrauded investors, to hold that money and to pay it back to them. It can be a very difficult job; and the particular receivership I am involved with has its own peculiar difficulties. Receivers are paid out of the assets of the estate. We are not paid by any State or Federal agency and, if there is no money, we are simply not paid.

In the particular receiverships that I am involved with, most of the money, almost all of it, had disappeared by the time the receiver was appointed and, therefore, a good deal of my effort has been involved obtaining the necessary funding in order to chase people as far as Panama.

Senator RUDMAN. I believe that you are involved in receiverships shown in that chart, if I am correct.

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[1] See p. 221 for the prepared statement of Edward T. Dangel.

Mr. DANGEL. Yes, I am intimately familiar with all of them. The people who were involved in the receiverships that I was appointed to were also involved in other schemes as well. In fact, the currency scam, the previous scam, was really a school for scoundrels. It was really a school to train the people to run this operation as well as they did and to make the money disappear as quickly as they made it disappear.

We are appointed by the court on the recommendation of either a State or a Federal agency. But after we are appointed, we report solely to the court. We have no official standing within the State or Federal agencies who appoint us. We have no particular access to records of the State and Federal agencies. We depend upon personal contacts and cooperations of the individuals in the agencies in order to obtain the records, the information we need to find the whereabouts of people who were involved in these scams.

Sometimes it is difficult because of ongoing investigations to get the records, to get the investigative files. For instance, in the cases I am involved in, many of the people who were involved just simply went into another business, another scam and because that came under investigation, it was very difficult to get investigative files. It was an ongoing investigation which has made my job even more difficult.

What our job is basically is to beat the pool operator. We are his natural enemy. There is an equation involved. When a telephone pool operator goes into this business, he knows there is a risk of being caught and he knows there is a risk of going to jail, and so there is an equation and that equation is, if I am caught and if I go to jail, what profits have I made? Is it worth it if I have to do the time? In other words, if I take in $3 million and I put $3 million away and I have to do 2 years, that's a pretty good deal.

It is our job to try to beat that equation. It is our job to try to get the money back even though it is put away in Switzerland, in this case in Panama, even though it is put into land in Nevada or California, even though it is transferred among the individuals, we try to get the money back so that even as they do the time and expect to come out whole, as it were, with the profits, we try to see to it that that doesn't happen.

The biggest problem we have in collection is delay. There is no early warning system here. Because of the cloaks of respectability that operators have at their disposal, because of the way these operations are set up, there is really an unsuspecting public. In fact, one of the good things about these hearings is: If there is widespread knowledge of what is being talked about here, the public may simply hang up the phone when the scam operator calls. They shouldn't buy commodity futures contracts over the telephone. Right now the public isn't aware and the public very often doesn't call either the CFTA or the State agency when they are called.

And when they do, there is a lead time which makes it difficult for the State agencies and the CFTA to know exactly what is going on and how to respond.

Furthermore, these companies take a good name. I think in the testimony we have just heard, we heard the names Jefferson and Lincoln. In the companies I am involved in, you have Ramco Petroleum, you have Bartex Petroleum. They sound pretty good. It is very easy to get WATS lines to use that are very impressive. You call the customer and the customer calls you back using an 800 number. It sounds pretty official. They select their customers carefully. It is easy to buy Dun & Bradstreet files that give names of unsuspecting people, people who may have bought these types of things in the past.

They know to cull out attorneys because attorneys apparently will complain too much when they are taken. They know how to cull the list down, they know who to go after.

In this particular case, in the case of CPI, a fictitious Dun & Bradstreet report was easily purchased by bribing an official of D & B down in Panama. It showed a $15 million net worth. This wasn't supposed to be passed out to the public but, of course, when Bartex got its hands on it, everybody who asked questions about these companies could very easily be sent a D & B report showing a $15 million net worth. That is a cloak of respectability that is difficult for an unsuspecting member of the public to disregard.

In addition, these fraud companies find it easy to advertise in the leading newspapers in the country. They advertise in the New York Times, they advertise in the largest newspapers in the country and some of the smallest ones as well. My investigation shows that only the Chicago Tribune has a lengthy questionnaire form which has to be filled out before advertising is placed in it for silver, gold, or oil commodity schemes.

In addition, it was easy for these companies because they kept large bank account balances, to obtain good references from helpful bank employees. In fact, an employee of a national bank has just recently been fired because he was willing to tell people over the telephone what a wonderful company "this company" was which had actually been banking with them for less than 2 months. Because the balances were large, the cooperation, in terms of wire transfers, giving out information to the public, was great.

Finally, there were brochures printed up and, of course, anybody can print a brochure that looks glossy, that looks good. The sales putch was well worked out, and so unsuspecting members of the public wired their money in and it was a period of a couple of months before people started to ask questions. And when the questions were asked, the first people to respond clearly, in this case, were the State agencies.

In Massachusetts, our securities division responded very, very quickly to inquiries. They closed down a couple of operations in Massachusetts in a period of less than a month. In New York State, the experience was the same. The CFTC was unable to move into this operation for a period of several months. In the meantime, most of the money had disappeared.

So as a receiver, I talk on a daily basis with people who have lost their life savings or who are substantially out of pocket, and the message I have to give them is a very unhappy one. It is one that we are trying very hard to get money back but it is going to be a difficult and long process and as we run into foreign banking laws and into difficult transfers, the chances of substantial recovery are perhaps not great.

Recently, we have had some encouraging news with regard to cooperation of former members of this scheme, but whether or not we will be able to recover back substantial funds, we still don't know.

I will answer any questions either after Mr. Fleming's statement or before, as you wish.

Senator **Rudman**. I think what we will do is have a brief recess at this time. Senator Nunn and I will go over to the floor and vote and we will return.

[Brief recess.]

[Members present at time of recess: Senator Nunn and Senator Rudman.]

[Senator present at start of hearing are Senator Rudman].

Senator **Rudman**. Mr. Fleming, if you would like to proceed with the summary of your statement, your entire statement and Mr. Dangel's entire statement will be included in the record.[1]

Mr. **Fleming**. Thank you, Senator.

I am the court-appointed receiver in two commodities futures frauds. One is a company called United States Investment Co., Ltd.; the other called Norwell Tradewinds, Ltd., both incorporated in Massachusetts and operating in Massachusetts but selling only to others; that is, people outside of Massachusetts. In fact, I want to emphasize, as far as I understand, they are very careful not to operate in Massachusetts.

The reason they were careful is, in the case of United States Investment Co., the Massachusetts Security Division was aware of their operation and had some questions about it. But since their operation wasn't the subject of any complaint, Massachusetts did not feel it was able to move on the company.

In the United States Investment Co. matter, we were able to recover or have recovered so far about $550,000. In the case of Norwell Tradewinds, we recovered $7,000. The total amount invested in United States Investment Co. by investors was $7 million and Norwell Tradewinds about $600,000. The United States Investment Co. operated for 2 years; Norwell Tradewinds approximately 10 months.

I would like to focus primarily on what I understand to have been the means by which the fraud was conducted. As we have heard in earlier testimony while I was present in the room, the operators and, in these two cases also, used canned pitches. They were very elaborate and very encouraging. United States Investment Co. claimed they were operating on both sides of the market so there will be no possibility of loss. That the performance of the company in the past was a 65-percent profit on the investment and they were asking in most cases an investment of $10,000.

Indeed, they did say in the statements that they sent to the investors periodically, the statements did show that they were operating on both sides of the market. That is, they bought a unit of soybeans, they also "sold" a unit of soybeans. So that was consistent. When their investors saw that, their salesmen's pitch was confirmed. The problem with that is the statements being sent to the investors were totally fabricated. They had no relationship to reality. From the very beginning of the operation, approximately 50 percent or more of the money received by the company from the investors was immediately put to use for the operations of the company, primarily to further the scheme by purchasing more advertising, purchasing more lists and making more direct mailings which, by the way, were the three main ways the United States Investment Co. got investors. They did not, to my knowledge, cold call anyone. They didn't buy lists to cold call. They bought lists to make mailings, and they did have, in that sense, a boilerroom.

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[1] See p. 227 for the prepared statement of Edmund E. Fleming.

The boilerroom only called those people from whom they got written response in the mails.

They advertised in the important business magazines, in the important national newspapers and in places like alumni journals or alumni magazines. One of the investors, for instance, I recall, learned of United States Investment Co. from the MIT Alumni Journal. I think that was fairly common, that is where they tried to place their adds. Of course, that added to their stature.

In the process of selling by phone after receiving a response, the individual salesman would give the potential investor a list of references to call to verify that the company was on the up and up. That list would include, it always included contacting the CFTC, and I will get back to that in a moment, contacting the bank with which USIC was doing business, contacting the Better Business Bureau and, if the investor had a relationship with Dun & Bradstreet, contacting Dun & Bradstreet.

The CFTC contact was, on its face, a very shrewd move. The CFTC answered, of course, under the statute that USIC was indeed registered and, in some cases, to my knowledge, also told the caller that USIC was registered as a commodity trading adviser. Now, it is not clear in most cases, as far as I understand, no one asked the question of what are the powers under the CFTC regulatory scheme of a commodity trading adviser.

If they had asked and if they understood what the meaning was, they would have known that USIC did not have the authority to receive the money that was being asked and being sent to them. But I don't think that it is clear—in other words, I think the statutory scheme of different registrations is itself confusing to the general public, and so inquiring of the CFTC and the CFTC giving them every bit of information they couldn't reveal the relevant information.

So the potential investor was satisfied that this company was "on the up and up," little realizing also that under the statute what the CFTC was saying is not that this company is good but that we don't know that this company is bad. And that, I think, is a serious fault.

The typical investor that I talked to also contacted the bank and the bank had designated an assistant vice president or vice president—I am sorry, I don't recall—a name to him and his name and telephone number were given to investors and when investors called, they were told, yes, USIC has two accounts here; their accounts are in the mid-six figure range, and we have no problems with the account. That created yet another aura of respectability, regularity and, in fact, respectability because, why else would a major bank designate a specific individual to perform that function. The Better Business Bureau would simply say that they had no complaints and, of course, that is logical, too, because the company wasn't operating in the Commonwealth, so there would be no complaints to that particular office. So that is how the investors became convinced that everything was on the up and up.

Most of the investors, even those who had been in there longer than 2 years, didn't ask for their money back, and I think the reason they didn't is because the statements they were receiving indicated that while they were gaining a little bit, they were also sometimes losing a little bit and they always had charges for what was called, fictitiously, margin insurance. So I think they were induced to keep their money there on the expectation that they would soom realize a 65-percent gain that they were promised.

That is basically how they were brought in and how they managed to stay in.

I have a couple of comments, if I may, about the enforcement activities. In the USIC case, as soon as—as I understand it—that the CFTC got any knowledge that the company was asking for money, they got that because incidentally someone who was a friend of a lawyer in Washington indicated to him "I have gotten this mailing, what is this company?" And that person, having a knowledge of the CFTC Act, said there may be something wrong with what is going on here, reported it to the CFTC virtually immediately. An accountant was sent to the USIC in April of 1981, performed an audit, quickly found that what was being represented in the statements sent to the investors was erroneous and false and within 3 days after his investigation, the CFTC ordered USIC to stop operations.

That was in early April. By the end of April, the receivership was in place by order of the U.S. district court, and I had been appointed. I think in this circumstance, the reason I was able to recover the money so far recovered is precisely because as soon as knowledge was available, action was taken.

[At this point, Senator Nunn entered the hearing room.]

Mr. Fleming. If I may, Senator, if I am not taking too much time, I have two or three more points I would like to make. Once the receivership was instituted, many people were advised—anyone who contacted me and anyone who contacted the CFTC were advised—of the reparations provision available under the act. Several of the investors followed that. The reparation procedure is, I think, in terms of a receivership, a totally irrelevant proceeding that requires extra work of the receiver, extra cost to the receivership an no benefit to the claimant. So I would recommend in any amendments of the act or the regulations that that matter be taken into consideration.

Senator Rudman. Mr. Fleming, we have now another rollcall so we have 15 minutes, and I would like in the 10 or 12 minutes we have before we have to leave to get into some questions. Before getting into any questions of a general nature, it is my understanding during the course of your inquiry following these funds, you had to go to the home of the principal of this corporation; is that correct?

Mr. Fleming. Yes, Senator.

Senator Rudman. I think it is very interesting what you found, and I would like to have it in the record. Would you show us what you found and describe it to us?

Mr. FLEMING. Yes, Mr. Kent, the principal of USIC, left on about the 10th or 12th of April after the CFTC ordered him to stop. I, among other things, went to his house and I found on his nightstand a book. The book is "Stealing from the Rich, The Home-Stake Oil Swindle." And in the book there is a page of notes, as far as I understand it, in Mr. Kent's handwriting. On the top it says, "Sentences for comparable crime" and he lists several and how much money was taken and how many months, and I emphasize months, in jail the perpetrators got.

In addition to that, he had a series of newspaper clippings from going back to 1976 on the same issues. So it seems fairly clear that for some period of time, he anticipated he was going to get caught, that he was going to put some money away and that he would have to spend a few months in jail for it.

Senator RUDMAN. I recall, he had a chart, so many million dollars and so many months in jail.

Mr. FLEMING. Yes, he did, Senator. For instance, in the Home-Stake production, they got $10 to $20 million he has listed here and he has three persons: Trippet, 3-years probation; Sims, 1-year probation; Fitzgerald, 1-year probation.

Senator RUDMAN. He evidently assumed for $10 million, 3-months probation wouldn't be a bad deal.

Mr. FLEMING. I guess he assumed on the basis of this he would be sent home with a handslap in the afternoon.

Senator NUNN. What was that book? Is that a regularly published book?

Mr. FLEMING. Yes, sir, a book "Stealing From the Rich" by David McClintock.

Senator NUNN. Have you read the book?

Mr. FLEMING. No, I haven't.

Senator NUNN. I just wonder, the title indicates illegal activities without any doubt. Is that the thrust of the book telling you how to actually commit crimes?

Mr. FLEMING. I think it's a story telling about the Home-Stake swindle. I think these list of people, Trippet, Sims, Fitzgerald, were some of the people involved in that. As I understand, and I haven't read it, it's an actual swindle that took place, how they did it.

Senator NUNN. It is not an instruction book on how to steal from the rich for everybody's general knowledge?

Mr. FLEMING. Well, it might be that also.

Senator RUDMAN. I just have two quick questions and then Senator Nunn may have some and maybe we can windup and let you gentlemen go back to Boston. I know you have spent a good amount of time here.

The question I have essentially is this: Do you find that as a result of the authenticity that registration lends to these operations that more and more of these con artists seem to want to get registered in any way that they can?

Mr. FLEMING. Yes, I think the registration, certainly in the case of U.S.I.C., added to the aura of respectability. I think it was from the point of view of perpetrating a swindle, a very useful move. So I think it was misleading to the public clearly.

Senator RUDMAN. Mr. Fleming, I also believe we have testimony about Lloyd Carr essentially from prison, setting up this operation in Boston. Is there evidence in your receivership some of these scams run out of prisons or orginated in prison?

Mr. **Fleming**. I don't know of anything originated in prison. Although in the U.S.I.C. case, Senator, my information is that Mr. Kent was convicted in the mid-1970's of stock fraud in which, I am told, over $300,000 was taken and was missing. He apparently served some time in prison for that and got out in 1975 or 1976. It was about 3 years later than that he started this commodities fraud and, in fact, started it in the same general area of Boston.

Senator **Rudman**. And it was registered.

Mr. **Fleming**. And it was registered.

If I just may say, I pursued that as well as I could. Why would this registration be issued? And there apparently are two or three explanations.

First, he changed the order of his name. He called himself Herbert Gerald Kent rather than Gerald Herbert Kent and used a different social security number.

When CFTC got that information and reported it to the FBI for a check, the computer information didn't turn up this other Herbert Gerald Kent. There was no evidence of any wrongdoing on his part.

Senator **Rudman**. Mr. Dangel, one question for you.

It seems Boston seems to be a focal point for a number of these operations that we see on our charts.

Is there any reason for this?

Mr. **Dangel**. I think Boston has a good reputation for "class", for brains and for financial institutions that are strong. I think Boston is used as another indicia or cloak of respectability. But I think the key to it is that although some operators centered in Boston, they extensively used WATS lines to reach people outside of Boston.

In fact, in the entire CPI scheme there were 600 investors or more and only one or two from the Massachusetts area.

So I don't think it is a question in any way of lax regulation.

In fact, I think the Securities Division does a bangup job and moves very, very quickly with very limited resources. I think it is the use of Boston as another indicia of respectability.

Senator **Rudman**. Senator Nunn?

Senator **Nunn**. What did both of you think about the CFTC and its abilities to regulate this illegal activity that is obviously growing?

Is the primary problem competency of people involved at the CFTC or is it one of numbers?

Mr. **Dangel**. I think it is one of numbers, Senator. I think there is simply too little staff, there just are not enough lawyers to handle this widespread off-exchange fraud. I think once the CFTC gets involved, given the difficulties inherent in prosecuting these schemes—they are very complicated and difficult for judges and juries to understand—they do a pretty good job of it. Particularly if the CFTC were to implement some of the enforcement concepts of Commissioner James Stone, it could be even more effective. But I think that the States need to be considered the early warning system and be very, very active, in fact, be the essential ingredient in these prosecutions because they seem to be able to act a little bit quicker than CFTC has been able to act.

Mr. FLEMING. Senator Nunn, I would say that any problems, from my point of view, the primary problem CFTC suffers are structural in the sense that the statute, for instance, on the registration issue, simply doesn't give them enough room to operate like the SEC or some other regulatory agency.

So I think that is their main problem from their perspective. The personal experiences I have had with the CFTC, both the Washington office here and the New York regional offices, they were very competent.

They acted as quickly as I thought they could act, and they did their job well.

Senator NUNN. Let me ask you one other question. We are running out of time here. We have 3 or 4 minutes to get over there.

If you were advising a would-be investor in commodities in a way that would alert them as to possible dangers, what kind of general rule would you have in the way of warning about people who might be victimized by this kind of fraud?

Mr. DANGEL. If you are solicited over the telephone, hang up.

Senator NUNN. Simply hang up.

Mr. DANGEL. Absolutely.

Senator NUNN. Would that include a call from Merrill Lynch and others?

Mr. DANGEL. I think it would.

Senator NUNN. Just don't go by the telephone.

Mr. DANGEL. Yes, sir.

Senator NUNN. What other rule?

Mr. DANGEL. I think the other thing is if you are somebody who doesn't have an extensive background in investment analysis, to find someone who really does have that expertise and talk to him about the potential investment.

Senator NUNN. How do you find that honest person? When you get Dun & Bradstreet reports on firms, how do you go about finding an honest person?

Mr. DANGEL. Well, I think the best way to do it is to call up a brokerage firm such as Merrill Lynch or a Shearson Hayden Stone and try to find if there is some way of finding out about this particular investment through investment analysts within the firm.

Senator NUNN. You are saying really that you ought to deal through well-known and major brokerage outfits.

Mr. DANGEL. I say that to some extent, yes. I say that commodities, futures contracts require sophistication. Even those contracts which are registered, those that involve lawful on-exchange activities require expertise. I am saying that if you are solicited over the telephone, chances are it is not from Merrill Lynch, it is from somebody you should really hang up the phone on.

Senator NUNN. Any other suggestions?

Mr. FLEMING. Senator, this may be saying it too strongly, but with the current structure and with the level of regulatory governing of the operations of commodity trades, I am not so sure an unsophisticated investor ought to be involved in the market.

I think it is so volatile and so dangerous——

Senator NUNN. You mean even where there is not fraud involved?

Mr. **Fleming**. Yes, because I think in order to be involved in knowledgeable investments, you have to keep track of so many, so many features, in fact, that there is simply no way for an individual to do that.

Senator **Nunn**. You say you might as well make a trip to Las Vegas or Atlantic City as get involved——

Mr. **Fleming**. Unless there is some way, Senator, to identify competent advisers and that, I think, takes further regulation. Competent advisers on what to invest in.

I think that is right. I think it is essentially a gamble.

Senator **Nunn**. Thank you, very much.

Senator **Rudman**. We will stand in recess now.

Gentlemen, thank you very much, and you are excused as witnesses.

We will be delighted to have you stay for the rest of the hearings.

[Members present at the time of recess: Senators Nunn and Rudman.]

[Member present after the taking of a brief recess: Senator Rudman.]

Senator **Rudman**. Our next witnesses are going to discuss the reparations process of those victims of commodity fraud.

Two witnesses, Curtis L. Washington and Richard J. MacMillan.

Raise your right hands.

Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Washington**. I do.

Mr. **MacMillan**. I do.

TESTIMONY OF CURTIS L. WASHINGTON AND RICHARD J. MacMILLAN, COMMODITY FRAUD VICTIMS (REPARATIONS DISCUSSION)

Senator **Rudman**. You may be seated.

Mr. MacMillan, I understand you are a resident of my hometown?

Mr. **MacMillan**. Yes, Mr. Rudman.

Senator **Rudman**. We want to welcome you here and welcome you here, Mr. Washington.

Mr. Washington, I believe you have a statement to tell us of your experience.

If you would like to proceed first.

Mr. **Washington**. My name is Curtis Washington. I am 38 years old and am employed as a probation officer for the county of Milwaukee, Wis.

I became involved with a firm called Republic Advisory Corp. and had set up a managed account with that firm after answering and ad in a magazine which was discussing commodities.

Before investing my money with Republic Advisory, I called the CFTC hotline number and found out that the firm and salesman were both registered. The salesman who called me in response to the card I sent in convinced me that his firm was the company to go with. He stated that $5,000 was my maximum risk and that there would be no margin calls. He also promised that I could end my investment at any time.

I opened my account in April, 1980 for $5,000. After a couple of months my account balance was below $2,500. I had asked to cancel the rest of the account and for return of my money but they stalled in giving it to me. Eventually they asked for a certified letter which I gave them, but they never sent me the money.

I called the CFTC and asked what I could do. They stated I could file a reparations claim with them, which I did in January 1981. In July 1981 I received a letter from the CFTC requesting me to pay a $25 filing fee. I was anxious for some action, and in November, I sent a letter to Congressman Reuss explaining my problem. He forwarded the letter to the CFTC hearing office and that same month I had a reply from the CFTC saying they were assigning the case to a judge.

In January of this year, I received a letter from the CFTC with a judgment stating that my case was dismissed without prejudice. That $5,000 represented $2,500 of savings and $2,500 of my mother's savings. I never even got the $25 back from the Government.

I also tried to get help from the Wisconsin Consumer Protection Bureau last year. They took my complaint and sent it to the CFTC, stating thay could do nothing else to help me.

I was very disappointed with the decision of the CFTC because the form letter didn't explain the decision at all. All it did was give me a date where I could file an appeal. I was also under the impression from a previous letter sent by the CFTC to Congressman Reuss, that I would receive a default judgment. Apparently I am supposed to try to find the defendants myself despite the fact these people were registered with the CFTC and they tried to serve them with the reparations papers at the registered address.

All in all I think the reparations process is worthless.

Senator RUDMAN. Mr. MacMillan, would you like to go ahead with your statement.

Mr. MACMILLAN. My name is Richard MacMillan. I am 34 years old and married with two school age children, and am self-employed as the owner and operator of a plumbing and heating contracting firm in Hudson, N.H.

In the fall of 1979, I received an unsolicited telephone call from a salesman representing himself to be with the International Trading Group. He called three times over a 1-week period, trying to get me to invest in crude oil futures contracts.

The salesman was very shrewd, charming, and a real professional at manipulating clients. I explained that I was not interested in oil, and about 2 weeks later he called me trying to sell silver futures contracts. He called six or seven times, generally between the hours of 8 and 9 o'clock at night trying to sell me 10,000-ounce contracts.

Finally on October 9, 1979, he convinced me to buy a 1,000-ounce contract for silver on margin for a fee of $1,750. My contract was for the purchase of the silver at $15.75 per ounce. The delivery date was February 9, 1980. I knew nothing about the deferred delivery contracts, and he explained every facet, pretty much to my understanding, stating if the value of silver rose to $17.50 per ounce, I would break even. Anything above that, I would realize a profit. In any event, I would not have to pay any margin balance.

A few days after I wired the $1,750 to the International Trading Group, I found out from a friend who works closely with the market that commodity options were illegal in the United States.

I talked to the salesman at International Trading Group about this and he said not to worry, we have been dealing with Euro-Swiss, a very reputable company in the field, and they were completely legitimate.

I had also contacted the CFTC prior to this on their hotline on the advice of my friend and checked out the International Trading Group and the salesman. They were duly registered.

I was under the impression that this meant the firms were bona fide and that if they were a sham, the Government would shut them down, naturally.

After the price of silver went up to $20 an ounce, the salesman kept calling me trying to get me to invest into more contracts.

I told him no, let me complete this one transaction first and then we will talk business after that.

Just before my contract was up, I tried calling the salesman, but had a great deal of difficulty. Finally, he answered and told me he couldn't fulfill the contract which had gone up to $34.85 an ounce. That would have netted me a profit of about $19,000 if it were legitimate. He said he was defaulting on the contract because his supplier, Euro-Swiss had gone bankrupt. He stated to me he knew how I felt, that he had his own mother leveraged heavily in the same commodities options so I shouldn't feel that badly, which was no great relief to me.

I called the CFTC hotline, and they told me I would file a reparations claim and they sent me forms. I sent the claim in on February 15, 1980. In August 1980, the CFTC requested my $25 filing fee, which I immediately furnished them. I did not hear from the CFTC again after their acknowledgement of receipt of the fee until January 25, 1982.

In that recent letter, which was received after I had agreed to come to Washington to testify, I was awarded a default judgment in the amount of $1,750.

Senator RUDMAN. Thank you, very much.

Mr. Washington, you have a letter in your possession to Congressman Reuss from the CFTC. There is a paragraph in that letter that seems to indicate you would get default judgment.

Would you read that paragraph for us?

Mr. WASHINGTON. Yes, I have a letter dated November 5, 1981, signed by Chairman Philip McBride Johnson.

In this letter, it indicates:

> Mr. Washington's complaint was filed with the complaint section on February 9, 1981, and was forwarded to the hearings section on June 3, 1981 for the Institution of Formal Adjudicatory Proceedings.
>
> This matter has now been assigned to Hearing Officer Robert Joost. As no answers have been filed by the respondents, this matter will result in a default judgment without oral hearing against the respondents if the respondents are found to have violated the Commodities Exchange Act.
>
> The record is presently being reviewed by the hearing officer and default judgment will be completed and forwarded to Mr. Washington within 60 days.

Senator RUDMAN. Now, in fact, that didn't happen.

Mr. WASHINGTON. No.

Senator RUDMAN. What did happen?

Mr. WASHINGTON. After I received this letter, I also received a reply from Congressman Reuss. In his letter, he indicated—this letter is dated November 9, 1981—he said:

> I have enclosed for you a copy of a November 5 letter which I received from Mr. Philip McBride Johnson, claim of the Commodities Futures Trading Commission regarding your complaint, R. 8138981499.

Mr. Johnson states that this case has been assigned to the Hearings Officer Robert Joost. He adds that:

> As no answers have been filed by the respondents, this matter will result in a default judgment if the respondents are found to have violated the Commodities Exchange Act, Mr. Joost is currently reviewing the records and default judgment will be completed and forwarded to you within 60 days.

Following that, I did not receive any information from the Commodities Futures Trading Commission until January 1981.

In a letter that I received from them, they gave me what their decision was and the facts it was based upon.

Senator RUDMAN. And would you tell us about that?

Mr. WASHINGTON.

> The Commission does not have personal jurisdiction over any name or over any person named or described as a respondent in a reparations complaint unless the Commission has acquired such jurisdiction.
>
> There was no actual service of process in this case with respect to any of the three persons named as respondents.
>
> A copy of the complaint was sent to each such person but the Postal Service returned each mailing to the Commission unopened because it is determined that each addressee had moved from the address set forth in the mailing and had left no new address with postal authorities.
>
> In the absence of some evidence of actual receipt of a complaint by respondent or by an agent of a respondent, the Commission cannot find that actual service of the complaint was made on that respondent.
>
> In conclusion, the Commission has no personal jurisdiction over the Republic Advisory Corporation, Lloyd Jacobs or Jerry King with respect to the subject matter of the complaint in this proceeding, in as much as there was no personal service of the complaint and no compliance with the rules provided for the constructive service of reparations complaints order.
>
> It is hereby ordered that the complaint in this proceeding be dismissed without prejudice. Signed Robert Joost, Hearing Officer.

Senator RUDMAN. So here we have a situation where obviously after registering with the CFTC, having submitted to their jurisdiction by registering with them, the best defense for the people who defrauded you was simply to disappear. And the statement of the administrative law judge, which I think is absurd, is that since they couldn't find him, even though they were registered with them, they did not issue a default judgment, but, instead, issued in their favor without prejudice and dismissed your complaint.

Mr. WASHINGTON. Yes.

Senator RUDMAN. What are you going to do now?

Mr. WASHINGTON. I have no alternatives. I will chalk it up to experience and just allow it to be a lesson for future investment activities I may have.

Senator RUDMAN. Certainly I think it would be an understatment to say you are not terribly pleased with the reparations process.

Mr. WASHINGTON. No.

Mr. **Weiland**. Mr. Chairman, could we have those two letters——

Senator **Rudman**. We would like to enter those into the record at this time.

[The documents referred to were marked "Exhibits Nos. 6 and 7," for reference, and follow:]

EXHIBIT NO. 6

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

November 5, 1981

The Honorable Henry S. Reuss
Member
U.S. House of Representatives
Washington, D.C. 20515

Dear Mr. Reuss:

This is in response to your letter of October 28, 1981 requesting information on behalf of a constituent, Curtis L. Washington, concerning his reparation proceeding, Curtis L. Washington v. Republic Advisory Corporation, Lloyd Jacobs and Jerry King, CFTC Docket No. R 81-389-81-499.

Mr. Washington's complaint was filed with the Complaints Section on February 9, 1981 and was forwarded to the Hearings Section on June 3, 1981 for institution of formal adjudicatory proceedings. This matter has now been assigned to Hearing Officer Robert H. Joost. As no answers have been filed by the respondents, this matter will result in a default judgment without oral hearing against the respondents if the respondents are found to have violated the Commodity Exchange Act. The record is presently being reviewed by the Hearing Officer and the default judgment will be completed and forwarded to Mr. Washington within sixty days.

We regret the difficulty your constituent has experienced in receiving responses to his inquiries concerning the status of the case. The small staff of the Hearings Section is presently processing approximately 1,500 reparation cases and, during the past several months, has necessarily relied on the notices served under our normal procedures to inform the parties concerning their cases where a default is involved.

In the event your constituent desires further information concerning this proceeding, he may direct his inquiry directly to the Hearing Officer with assurance that a reply would be forwarded promptly.

Sincerely yours,

Philip McBride Johnson
Chairman

HENRY S. REUSS
5TH DISTRICT, WISCONSIN

WASHINGTON OFFICE:
2413 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
PHONE: 202-225-3571

MILWAUKEE OFFICE:
FEDERAL BUILDING ROOM 400
517 EAST WISCONSIN AVENUE
MILWAUKEE, WISCONSIN 53202
PHONE: 414-291-1331

Congreſs of the United States
House of Representatives
Washington, D.C. 20515

COMMITTEES:
JOINT ECONOMIC COMMITTEE
CHAIRMAN

BANKING, FINANCE AND
URBAN AFFAIRS COMMITTEE

November 9, 1981

Mr. Curtis L. Washington
5573 West Brooklyn Place
Milwaukee, Wisconsin 53213

Dear Mr. Washington:

I enclose for you a copy of the November 5 letter which I have received from Mr. Philip McBride Johnson, Chairman of the Commodity Futures Trading Commission, regarding your complaint #R 81-389-81-499. Mr. Johnson states that this case has been assigned to Hearing Officer Robert Joost. He adds that "as no answers have been filed by the respondents, this matter will result in a default judgment...if the respondents are found to have violated the Commodity Exchange Act". Mr. Joost is currently reviewing the record, and a default judgment will be completed and forwarded to you within 60 days.

I hope that this information is useful to you. If you have any additional questions or comments that you would like me to put to Commission officials, please let me know.

Sincerely,

Henry S. Reuss

Henry S. Reuss
Member of Congress

Enclosure

EXHIBIT NO. 7

UNITED STATES OF AMERICA
before the
COMMODITY FUTURES TRADING COMMISSION

CURTIS L. WASHINGTON,

Complainant

v.

REPUBLIC ADVISORY CORP., LLOYD JACOBS, and JERRY KING,

Respondents

CFTC Docket No.
R 81-339-81-499

INITIAL DECISION

JOOST, Hearing Officer: This is a proceeding under section 14 of the Commodity Exchange Act[1] between a person complaining of a violation of or under that Act and alleged registrants[2] who are accused by that person of having committed such violation.

The complaint was received by the Commission on February 9, 1981. The Commission's delegee mailed, to two of the three individuals named as respondents and to the corporation mentioned in the complaint, a copy of this complaint and an official letter stating that each must satisfy the complaint, or answer it in writing, by June 1, 1981.

The Commission's mailing was sent by certified mail, return receipt requested, to respondent Republic Advisory Corp. at the address given to the Commission by the complainant. The mailing was returned unopened to the Commission marked "moved, left no address."

The Commission sent separate mailings by certified mail, return receipt requested, to respondent Jerry King and respondent Lloyd Jacobs in care of Republic Advisory Corporation at the same address. Both mailings were returned unopened to the Commission marked "moved, left no address."

---

[1] 7 U.S.C. 18 (1976). The proceeding is governed by the regulations adopted under that section by the Commission, which are termed the rules relating to reparation proceedings (hereinafter "rules"). 17 C.F.R. 12.1 et seq. (1980).

[2] The term "registrant" is defined in the Commission's rules to mean either a person registered with the Commission as a commodity professional or a person required so to register pursuant to the Commodity Exchange Act. 17 C.F.R. 12.3(q)(1980).

On June 3, 1981, the Commission's delegee determined that a formal adjudicatory proceeding should be instituted between Curtis L. Washington, complainant, and Republic Advisory Corp., Lloyd Jacobs, and Jerry King, respondents.

The matter was certified to the Chief Administrative Law Judge on that date and assigned to this Officer for the rendering of an initial decision. , The reparation damages claimed by the complainant are $2,855.

FINDINGS OF FACT

The following findings are made on the basis of the record in this proceeding:

1. The respondent Republic Advisory Corp. did not receive a copy of the complaint and is not aware of the contents or pendency of the complaint.

2. The respondent Lloyd Jacobs did not receive a copy of the complaint and is not aware of the contents or pendency of the complaint.

3. The respondent Jerry King did not receive a copy of the complaint and is not aware of the contents or pendency of the complaint.

4. A copy of the complaint was sent to each of the aforementioned respondents by the Commission by certified mail, return receipt requested, but each separate mailing was returned unopened to the Commission as undeliverable because the addressee had moved and left no new address.

5. None of the three respondents moved, without giving the Postal Service a forwarding address, in order to avoid actual receipt of this complaint or other reparation complaints or to avoid the reparation jurisdiction of the Commission.

6. None of the three respondents was in fact registered with the Commission as a commodity professional.

7. Each of the aforementioned Commission mailings was sent to the respondent designated at the address for that respondent furnished to the Commission by the complainant.

8. A copy of the complaint was not sent to any of the three respondents at their principal place of business as shown in the records of the Commission.

9. The Commission does not have personal jurisdiction over Republic Advisory Corp., Lloyd Jacobs, or Jerry King for purposes of adjudicating the merits of this complaint.

DISCUSSION OF LAW AND FACTS

The Commission does not have personal jurisdiction over any person named or described as a respondent in a reparation complaint unless the Commission has acquired such jurisdiction by appropriate service of process.

There was no actual service of process in this case, with respect to any of the three persons named as respondents. A copy of the complaint was sent to each such person, but the Postal Service returned each mailing to the Commission unopened because it determined that each addressee had moved from the address set forth in the mailing and had left no new address with postal authorities.

In the absence of some evidence of actual receipt of a complaint by a respondent, or by an agent of a respondent, the Commission can not find that actual service of the complaint was made on that respondent.

Personal jurisdiction over a respondent in a reparation proceeding can also be acquired by constructive service of process, if the requirements for such service are satisfied. "Section 12.22 of the Reparation Rules provides for constructive service of reparation complaints, . . . so long as the complaint is mailed to the respondent in compliance with Section 12.22 of the Reparation Rules."[3/]

There was no such compliance in this case.

Section 12.22[4/] requires that a copy of the reparation complaint be forwarded to any registrant to be served at either--

(1) an address designated by that registrant with the Commission as an office for the receipt of reparation complaints; or

(2) the registrant's principal place of business as shown in the records of the Commission.

There is no evidence that any of the three registrants

[3/] Troll v. Lloyd, Carr & Company, Comm. Fut. L. Rep. (CCH) ¶20,676, p. 22,758 (C.F.T.C. 1978).

[4/] 12 C.F.R. 12.22 (1980).

had ever been in fact registered with the Commission or had ever designated an address with the Commission for purposes of receiving reparation complaints. There is also no evidence that the Commission's delegee, the Complaints Section, forwarded a copy of the complaint to each respondent at the respondent's principal place of business as shown in the records of the Commission.

In fact, the mailings were sent to an address designated by the complainant in the complaint as the address at which each respondent could allegedly be found.

CONCLUSION

The Commission has no personal jurisdiction over Republic Advisory Corp., Lloyd Jacobs, or Jerry King, with respect to the subject matter of the complaint in this proceeding, inasmuch as there was no personal service of the complaint and no compliance with the rule providing for constructive service of reparation complaints.

ORDER

It is hereby ordered that the complaint in this proceeding be dismissed without prejudice.

Signed this 15th day of December, 1981.

Robert H. Joost
Hearing Officer

Senator RUDMAN. Mr. MacMillan, you have a judgment.

Mr. MACMILLAN. I do, Senator Rudman.

Senator RUDMAN. What will you do with it?

Mr. MACMILLAN. I have it in a drawer at home some place. It is stated that a U.S. judge had found in my favor in this reparations case and within 15 days, if there was no reply from International Trading Group, that I would be awarded the $1,750.

That time has come and gone and there has been no other correspondence from the CFTC, and basically it didn't tell me how I go about obtaining those funds.

I suppose I should go down to the U.S. marshal and say, "See what I got."

Senator RUDMAN. Essentially, Mr. Washington had his case dismissed without prejudice because they could not find them. You get a default judgment but essentially neither one of you has heard anything in terms of what you might be doing in terms of getting restitution.

Mr. MACMILLAN. As far as I know, International Trading Group no longer exists. Unfortunately, the CFTC probably doesn't know this. There is no sense in my getting excited by them saying I am going to get the money back because that is not going to be the case.

Senator RUDMAN. We thank you both for being here today.

It is important we have your testimony in the record as we attempt to move toward some important legislative change that will hopefully make this process better in the future.

Thank you, very much.

We will have Henry Eschwege from the GAO and Roy Geffen, who is staff investigator of the subcommittee.

As you know, it is customary to swear in all witnesses before PSI, so anybody who is going to testify.

Mr. ESCHWEGE. Mr. Chairman, this gentleman here is Ralph Lowry. It is all right for him to sit at this table?

Senator RUDMAN. Certainly. Is he going to testify?

Mr. ESCHWEGE. I think he will.

Senator RUDMAN. Do you swear the testimony you are about to give in the course of this hearing will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. ESCHWEGE. I do.

Mr. LOWRY. I do.

Mr. GEFFEN. I do.

Senator RUDMAN. Thank you, you may be seated.

TESTIMONY OF HENRY ESCHWEGE, ACCOMPANIED BY RALPH LOWRY, GAO; AND ROY GEFFEN, STAFF INVESTIGATOR

Senator RUDMAN. Mr. Eschwege, I understand you have a statement.

Mr. ESCHWEGE. Yes, sir.

Senator RUDMAN. We will put the entire statement in the record and if you could summarize it for us, we would appreciate it.[1]

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[1] See p. 235 for the prepared statement of Henry Eschwege.

Mr. ESCHWEGE. Mr. Chairman, it is a relatively short statement but I will try to delete some sections of it to make it faster.

I would like to say we have done a comprehensive review of the Commodity Futures Trading Commission. However, we have been aware of the work that the staff of this subcommittee has done, and we have coordinated our efforts with theirs where we have focused more on the procedural matters which we feel would help to avoid certain abuses.

We will talk briefly about three subjects—reparations, registration and audits and financial surveillance.

Our work revealed that the reparations program is not meeting its objectives. Available statistics compiled by CFTC on the reparations program are not up to date or complete; however, the most recent data CFTC could supply us indicates that a reparations claim filed in 1978 took almost 3 years to complete the entire process.

In fact, as of August 1981, only 53 individuals had actually received money as a result of reparations decisions. Our discussions with the complainants and commodity attorneys indicated that complainants had considerable difficulty understanding important aspects of the program, including how to enforce decisions and collect judgments.

Reparations can be expensive, with commodity attorneys citing fees ranging from $1,000 to $10,000 for handling relatively small reparations claims.

Arbitration is potentially an effective and attractive alternative to reparations, especially for smaller claims. However, several factors have limited its use. Because arbitration panels include industry officials, both customers and commodity attorneys perceive these panels as having a pro-industry bias.

Just as significant, many customers are not even aware that arbitration exists. Commodity exchange arbitration programs have additional drawbacks. For example, their jurisdiction is limited to disputes which concern their members' actions on their exchange.

Further, the act places an unrealistically low $15,000 ceiling on the size of a claim which customers can compel exchange members to arbitrate.

The relatively high cost of court litigation makes it a useful alternative to reparations only for claims involving large amounts or difficult and complex issues. However, the Supreme Court now has under review the question of whether the Congress intended commodity customers to have a right of action under the act to sue CFTC registrants in Federal court.

To provide for more effective resolution of customer claims, CFTC needs to improve reparations program management, simplify its operation, and support the development of arbitration at the exchanges and the National Futures Association.

To resolve the issue of whether commodity customers can take their claims to Federal court, the Congress should clarify its intent regarding whether customers have a private right of action to adjudicate commodity related claims in this forum.

Turning now to registration, at present, registration is not required in an important area of the futures business, salespersons and supervisors of Commodity Trading Advisors and Commodity Pool Operators.

Commodity Trading Advisors advise the public on trading strategies, while Commodity Pool Operators function in a manner analogous to mutual funds, investing the combined resources of many individual traders.

Although the principals of these firms must register with CFTC, we believe that registration should also be required of the salespersons and supervisors who actually solicit business.

CFTC can take additional action to assure registrants' fitness. It can require futures commission merchants to sponsor and review the registration application of persons associated with their firms. It can also fingerprint registrants and submit their fingerprints to the FBI for review.

I think that if the CFTC had fingerprints of some of their registrants, they might have been able to disclose past criminal actions and avoid some of the scams that have been committed.

CFTC does not periodically recheck registrants against FBI or Securities and Exchange Commission files, or its own records to determine whether the registrant has committed acts which would make him no longer fit for registration. This has to do with the activity of re-registration.

Because futures trading requires substantial knowledge and is highly complicated, qualification standards and proficiency testing could also help CFTC protect futures customers. CFTC has proposed but has not finalized, rules which would require a proficiency examination as a condition of registration for persons associated with futures commission merchants.

The newly created National Futures Association can address some of the weaknesses in the registration program since it is expected to assume many of CFTC's responsibilities. CFTC, however, needs to take a more active role in planning for the transfer of registration functions to the association.

Let me now turn to the audit function. CFTC has overall responsibility for insuring that customer funds are properly safeguarded. Through enforcement of segregation of funds, recordkeeping, and minimum financial requirements, CFTC attempts to deter financial failures and detect improper financial practices which could result in the loss of customer funds. CFTC shares this responsibility with the commodity exchanges, which establish and enforce minimum financial requirements for their members. CFTC oversees the exchanges' implementation of their audit and financial surveillance programs.

CFTC needs to shift more of the audit responsibilities to the exchanges and the National Futures Association when it becomes operational.

In doing so, however, CFTC needs to improve its own program for monitoring exchange audit and financial surveillance activities.

This shifting of focus will allow CFTC to devote more audit resources to areas of the industry for which it is primarily responsible.

That briefly summarizes the statement I was going to present.

Senator RUDMAN. Mr. Geffen, we are going to incorporate the entire staff statement for the record at this time and not ask you to summarize it. I will simply ask several questions of you and Mr. Eschwege, unless you have any comments you would like to make in particular expressed from your testimony.[1]

Mr. GEFFEN. No, sir, I don't. That will be fine.

Senator RUDMAN. I have a question for you, Mr. Geffen, and simply ask you this: I guess we have overwhelming evidence before this subcommittee from every witness that registration before the CFTC is a very important tool that helps some of these con artists get by. It gives them authenticity, credibility. Is that verified and corroborated in all of the investigations that we have done at the staff level?

Mr. GEFFEN. Most definitely. Of all the victim witnesses we talked to who had filed anything at all with the CFTC, or even with a law enforcement agency, the fact the registration process was touted by the firms was one of the utmost actions that made them invest in the first place. They called the hotline number, they were told the firm was registered or the salesman was registered and in all the cases where this was a fact, which is most of the people we talked to, it turned out to be one of the main reasons why they decided to invest with these firms.

As far as they were concerned, that was about all they could do to check out the firms.

Senator RUDMAN. Mr. Eschwege, one of the things that we are considering here is legislation that will expand the areas, if you will, of prosecution by the States, particularly in the criminal area. From an overview of what you looked at in your entire report, it seems to me at least from your testimony and from what we have seen, it would take an enormous buildup of the CFTC to do the kind of things your report indicates has to be done when, in fact, there are pretty large law enforcement apparatuses on behalf of the States that, in fact, can handle much of this. What is your reaction to that?

Mr. ESCHWEGE. My reaction to that is, No. 1, CFTC may need some additional resources. However, we also point out in our draft report that there is in some cases an improper use of existing resources, that there are some things that can be shifted onto the futures association, the exchanges, and others. For instance, in terms of getting the States more involved in litigation, we were addressing this issue, to some extent, already 4 years ago, and we see some movement in that direction, based on the chairman's testimony yesterday where he pointed out, at least with respect to the off-exchange transactions, and the nonregistrants, that he is willing to turn that over to the States. Also he wants to give to the States, with the permission of this legislative body, some of the information that he can not now provide those States.

Senator RUDMAN. Certainly we had excellent testimony by an assistant attorney general of the State of New York. He appeared before us yesterday. He indicated the State of New York alone has more resources available to it than that one office of the entire CFTC and that can be said for many States as well.

Certainly your audit, your report here seems to indicate to me that unless we are willing to build a huge agency with nationwide law enforcement capabilities, that the only way we are going to get a handle on this is to start sharing some of this responsibility because the States, in fact, prosecute fraud in most other areas.

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[1] See p. 145 for the prepared staff statement.

Mr. **Eschwege**. Mr. Chairman, I might add one other thing. Four years ago, we suggested that one possibility to enlarge the staff that would be involved in prosecution would be for the States to come in and say "we would like to prosecute in this case, but we would give you, the Commission, first crack at it if that is what you want." But if they were to refuse, the States could go in and litigate.

Senator **Rudman**. The problem is, when Mr. McMillan from Hudson, N.H., if he got defrauded out of some money because he purchased land in northern New Hampshire or a condominium in northern New Hampshire that, in fact, cost him a great deal of money and was nonexistent and was a type of one of the many scams, the State of New Hampshire has an apparatus to follow that quickly through law enforcement agencies, to get their hands on assets, to start a very fast recovery, and bring criminal action.

That is really the way Government is supposed to work. The Federal Government moves like a sleeping turtle largely because it is large and cumbersome. In many cases agencies are given staff that are inadequate for the job by the Congress, and it just seems to me if someone is defrauded of money, it does not make too much difference what the mode was, the difference is how fast you can get response. Of course, I think that is the way we are heading. I was pleased to see the chairman's comments yesterday.

Thank you very much for appearing here this morning.

Our final witnesses for today are Michael Unger, securities commissioner from Massachusetts, and K. Houston Matney, securities commissioner from the State of Maryland.

Gentlemen, if you would raise your right hand.

Do you swear the testimony you are about to give in the course of this hearing shall be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. **Unger**. I do.

Mr. **Matney**. I do.

Senator **Rudman**. Mr. Unger, would you like to proceed with a summary of your statement?

STATEMENTS OF MICHAEL UNGER, SECURITIES COMMISSIONER, MASSACHUSETTS; AND K. HOUSTON MATNEY, SECURITIES COMMISSIONER, MARYLAND

Mr. **Unger**. Yes, thank you, Senator.

I am appearing here on behalf of the North American Securities Administrator's Association. You heard some of our colleagues yesterday. That statement was submitted on my behalf as well, and on Mr. Matney's behalf.[1]

There was some discussion yesterday by my colleagues that the preemptive provisions of the Commodities Exchange Act has done a disservice to the investors of our respective States. We are pleased that pending legislation that has been filed by the CFTC may return some of that jurisdiction to the States to enable us to combat commodities fraud.

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[1] See p. 195 for the statement of the North American Administrators Assoc., Inc.

We have in the past done that and we want to continue to do it. Many of our State securities administrators plus our association have invested considerable time and money to combat commodities fraud and in preparation for these hearings. I would like to thank you, Senator, and the rest of the members of the subcommittee as well as the staff, in particular the chief counsel for putting together a very important effort.

Your heard the horror stories yesterday and some more tales were unwound today.

From our perspective, the thrust of the problem is that the primary mandate of the CFTC is not to regulate sales practices, but to insure orderly markets at a national and international level. That is important, it has to be done and there is staff to do that, but they are not adequately staffed to deal with sales practices.

Their primary intent is not to deal with sales practices, but yet enormous sums of capital are wasted every year by fraud perpetrated by people and by firms who do not register, as well as many firms that do register and run afoul of the law.

The thieves run from one firm to another and one State to another. There is a great time lag between the period when the CFTC becomes aware of a fraud and until injunctive action is filed. There have been occasions, I think they are rare, when action is taken quickly; but our own experience in Massachusetts has been, that we often know far in advance when there are bad guys perpetrating fraud within Massachusetts and outside our borders and we are powerless to do anything because they are registered with the CFTC.

We have taken action against many of the boilerrooms that are not registered. We have filed litigation in State court under consumer protection statutes and our Securities Act.

When our agency received cease and desist authority, we started to issue cease and desist orders. We are able to do that quickly. Sometimes that is effective because we do it with attendant publicity and the public is warned. Our experience has been that the cheats pull up and leave, but they go someplace else. They will go down to Florida, Maryland, and try again.

Injunctive relief available to the States under section 6(d) of the CEA as well at CFTC, only stops something that has occurred for a long time and tells people to stop violating the law. They are not supposed to do that to begin with. The best way to constrict such fraud is to prosecute these people criminally and create a deterrent effect.

We would encourage the subcommittee strongly that any legislation that is presented before the Congress be very clear and unambiguous about the States' authority to utilize their statutes, criminal statutes and securities statutes, to prosecute fraud.

NASAA is proposing legislation in the area of registration. You heard a lot about that this morning. We thought long and hard about this, and we realized the industry would very likely oppose any effort to register people in every State in which they practice with a good deal of aggressiveness. Perhaps it is not very practical to require registration in every State for purposes of uniformity.

We have come up with what we believe to be a workable compromise that might pacify the legitimate members of industry, while at the same time provide a line on those people who may seek to cheat the public.

What we are suggesting and believe would be a workable solution is that when a person registers with the CFTC, and I am talking about anybody who has anything to do with sales, except clerical and back office people, anybody who is going to advise or sell to the public, should be registered. When that is done at the CFTC, they indicate to the agency which States they are going to practice in, not reside or set up office, but where they are going to sell. Having done that, the CFTC, through some mechanism, which could be resolved through regulation, would notify various States' securities administrators that Sam Jones is registered with us and is going to practice in your State. We will then know, we will be able to keep an eye on Sam Jones. We will be able to see what he is doing.

We can check with the telephone company and see if they have ordered a bank of 20 phones. We can see if they set up a phony mailing address in downtown Boston but set up a shop in a less expensive suburban area. Having done that, the States can monitor, to a very large degree, the efforts of commodity sales people, and if we find something is wrong, we can then petition, and we would suggest in the legislation that we be given authority to petition, the CFTC to institute revocation proceedings or other disciplinary proceedings against somebody who has violated the Commodities Exchange Act.

Congress then should mandate that the CFTC act promptly to resolve that petition. The agency may find there is no basis to the petition or they may find there is. I think that would provide a very, very important, useful, workable, noncumbersome tool for the CFTC to work closely and carefully with the States in policing commodity sales. I think it would go a long way to resolving some of the problems because it has had a very large deterrent effect on people practicing in the sales area.

I will briefly touch on leverage contracts which currently are not subject to State legislation. NASAA's position is that they should be. There is no logical reason why they shouldn't be treated as securities. There is an exception carved out in the CEA which permits leverage contracts to be regulated by the CFTC. Many of those firms, in fact, practice boilerroom tactics. They should be registered and policed by the States. CFTC can do it as well, but we would like to do that.

The testimony just before us made mention about the NFA. We are not as optimistic about the National Futures Association undertaking with great vigor policing mechanisms of their industry for several reasons: One, they don't have the historical background or experience one might find at the NASD, the SRO for the securities industry. The legislative provisions given to the CFTC do not anywhere approach the authority, powers, or level of regulation that is found in the Securities and Exchange Commission.

The commodities industry has fought tooth and nail, from our perspective, every progressive attempt to provide regulatory protection to investors. They see it as burdensome and costly. I think that is a narrow perspective.

Every time there is a scam or scandal publicized, it hurts the legitimate people in the industry. I think the cost benefit of effective regulation is far greater than the minimal costs associated with additional regulation. The National Futures Association is going to be an industry-controlled group. There are many good thinks they can do such as audit functions and perhaps registration functions, but they will not be a panacea for the fraud that exists. We just do not see that happening.

There are many firms registered with the CFTC and who wield a lot of clout within the industry who, in fact, conduct boilerroom operations. We have one in Boston. We get several complaints about them a month, yet they are powerful, they are effective and they no doubt will wield a strong voice within the NFA. The NFA should not replace the efforts of the States to police commodity frauds, whether through registered or unregistered firms.

We will support strongly the information-sharing efforts and language that stresses cooperation between States and the CFTC that is presently in pending legislation. We would encourage you as well to lend support to that effort.

Last, we encourage the subcommittee to seriously consider some method or mechanism whereby the CFTC would be obliged to provide investor suitability standards.

There is a rule for the securities industry that a salesperson know that the investment vehicle he is putting his clients into be suitable for that individual's circumstance.

Commodities are no different. We are not talking about farmers protecting themselves through hedging, there are plenty of people who do that. But the commodity industry has moved a long, long way from where it was 5 or 10 years ago. It now has many characteristics similar to securities investments. People selling to the public should be required to make sure the investments they are selling are suitable for that person's needs.

Industry has fought that idea tooth and nail and, in fact, the Commission, with the exception of former Chairman James M. Stone, struck down any efforts at investor suitability rules. It is a self-policing mechanism that is very useful to the industry. It enables a firm to police their own salespeople who may be overzealous.

We encourage a hard look at investor suitability to be an easy way to provide some restraints on the overzealous.

I conclude my remarks. Mr. Matney and I are available for any questions.

Senator RUDMAN. Your entire statement will be incorporated in the record.

Do you wish to make a summary of that statement?

Mr. MATNEY. Senator, I think my colleague has very eloquently stated our position on that. I will be available to answer some questions.

Senator RUDMAN. Mr. Unger, is it true that on one occasion you warned the CFTC about a potential registration about to take place and that, in fact, the registration took place anyway?

Mr. **Unger**. Yes, I do not remember the name of the individual, Senator. It was connected with Ramco, which was a sales operation involving Bartex that Mr. Dangel talked about today. We learned that person was going to set up a firm, and we sent a letter to the CFTC saying we had heard about this, just letting them know, and they proceeded to go ahead and register him.

There are people, we call them sons of Lloyd Carr, who were very aggressive and successful salesmen of Lloyd Carr, who went on to set up their own shops in Massachusetts.

Senator **Rudman**. And were registered?

Mr. **Unger**. Absolutely.

One is Peabody Trading, a fellow by the name of Norbert Lynch. They were audited by the CFTC the summer of 1981, I believe.

The CFTC found problems. When they came back 2 weeks later, the guy shut the doors. Boston Trading Group, same thing happened. The intentions of the agency were very good. They just don't have the resources to do the job quickly enough.

Senator **Rudman**. Had you had total jurisdiction in your office working with the Attorney General's Office of Massachusetts and Lloyd Carr, after closing down, with a number of his former employees moving back into the field, what would you have done?

Mr. **Unger**. If we had registration authority to begin with, I doubt seriously whether they would have been registered at all. If they then attempted to set up shop outside of registration, they would be prosecuted. We first stop them civilly because it can be done more quickly than proceeding criminally.

Senator **Rudman**. There is very little doubt in your mind or in your various colleagues' minds that unless we start sharing this jurisdiction with the States, this problem will not get any better.

Mr. **Unger**. Absolutely. The growth of this industry is not going to decrease. The imagination and creativity of the industry in providing new investment vehicles to the public is unbounded, and the public, as inflation increases, is going to become more interested.

Senator **Rudman**. Mr. Matney, I believe your office has had at least one joint case with Federal authorities. Can you tell us a bit about that? Was registration a factor in that case? How did the joint plaintiffs work out and how did the case conclude?

Mr. **Matney**. Senator, we were involved in one joint action with the CFTC in the case of Annapolis Funding Co., involving unregistered sales of precious metals, commodity options. It was identical to a case that the Maryland Securities Commission back in 1973 initiated against a company strictly under the Maryland Securities Act wherein we were able to have an ex parte receiver appointed and approximately 50 cents on every dollar returned to investors within a period of several months.

As a result of the preemption language, even though we commenced our own investigation in the Annapolis Funding case, we were about 2 months into that investigation when we crossed paths with the CFTC and, at their request, we went forward jointly. It was approximately 6 months after our investigation had commenced before suit was filed.

It was another 6½ months before the case was brought to a conclusion in the form of a consent settlement in the Federal District Court in Maryland accompanied by separate out-of-court administrative settlements with CFTC and our division on the securities law. It was a very frustrating experience for us.

I should point out that our frustration was not with either the personnel or the policies of the Enforcement Division of the CFTC.

We have considerable respect for them in our State as good law enforcement officials. However, they were considerably restricted by what I perceive to be Commission level policy decisions or nondecisions and by the bureaucracy, if you will, the chain of command running from Commission level to General Counsel and then down to the Enforcement Division.

We ultimately brought the case to a successful conclusion, so I can say that our one joint action worked. However, I would point out it took a little over 1 year to bring that case to a conclusion.

In the meantime, with the exception of about the last 2 weeks of that proceeding, the principals continued operate at full scheme taking in approximately one-half million a month. By the time a receiver was appointed, I think he walked in to find something like $7,000 in assets remaining. We notified the enforcement division that because of the frustrations, particularly delays, we didn't think it appropriate utilization of State resources to proceed in future cases by way of joint action.

Several months ago we discovered another boilerroom operating in the State of Maryland, Capital First Financial operation affiliated with the so-called North American Coal Exchange.

In that case, after a preliminary investigation determining there was in fact a boilerroom activity and that the nature of the contracts being sold were such to constitute investment contracts under the securities laws, notwithstanding the pre-emption, we notified the enforcement division of the CETC and prepared to proceed under the State's Securities Act and with their passing acknowledgement and behind the scenes support, we went administratively by issuing a summary cease and desist order, and I think from the time we commenced that investigation until the boilerroom was shut down in the State of Maryland, which was our primary objective, total time consumed was between 4 to 6 weeks; a remarkable difference.

Senator RUDMAN. The proof is that States move in a whole variety of areas—fraud areas, consumer divisions, securities division, insurance departments do so with some alacrity. That is because you are there.

Gentlemen, I want to thank you very much for appearing. That concludes today's hearing.

Tomorrow we will be hearing from the chairman of the CFTC and that will be the conclusion of these hearings.

The subcommittee will stand in recess then until 10 a.m. tomorrow in this room.

[Whereupon, at 12:40 p.m., the subcommittee was recessed, to reconvene at 10 a.m, Thursday, February 25, 1982.]

COMMODITY INVESTMENT FRAUD

THURSDAY, FEBRUARY 25, 1982

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE COMMITTEE ON GOVERNMENTAL AFFAIRS,
Washington, D.C.

The subcommittee met at 10:03 a.m, pursuant to recess, in room 3302, Dirksen Senate Office Building, under authority of Senate Resolution 361, dated March 5, 1980, Hon. William V. Roth, Jr. (chairman of the subcommittee) presiding.

Members of the subcommittee present: Senator William V. Roth, Jr., Republican, Delaware; and Senator Warren B. Rudman, Republican, New Hampshire.

Members of the professional staff present: S. Cass Weiland, chief counsel; Tom Karol, staff counsel; Eleanore J. Hill, chief counsel to the minority; and Katherine Bidden, chief clerk.

[Member present at convening of hearing: Senator Roth.]

Chairman ROTH. This morning we will conclude a 3-day set of hearings into the extent of commodity investment fraud schemes and the reaction of various government authorities to the problems.

We are pleased to have with us Philip Johnson, who, I guess, this last June became Chairman of the Commodity Futures Trading Commission, an acknowledged expert on commodity law in the United States. We worked closely with Chairman Johnson and members of his staff, and we appreciate the cooperation they have shown to our various inquiries. Chairman Johnson, if you would come forward and please stand. It is a subcommittee rule that you have to be sworn in, so anyone who is going to be answering questions, raise your right hand.

Do you swear the testimony you will give before the subcommittee will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. JOHNSON. I do.

Mr. MANLEY. I do.

Mr. LOUGHRAN. I do.

Mr. COTTON. I do.

Mr. DUTTERER. I do.

[The letter of authority follows:]

U.S. SENATE,
COMMITTEE ON GOVERNMENTAL AFFAIRS,
SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
Washington, D.C.

Pursuant to Rule 5 of the Rules of Procedure of the Senate Permanent Subcommittee on Investigations of the Committee on Governmental Affairs, permission is hereby granted for the Chairman, or any member of the Subcommittee as designated by the Chairman, to conduct open and/or executive hearings without a quorum of two members for the administration of oaths and taking testimony in connection with hearings on Commodity Investment Fraud Schemes, on Tuesday, February 23, Wednesday, February 24, and Thursday, February 25, 1982.

William V. Roth, Jr.,
Chairman.

Sam Nunn,
Ranking Minority Member.

Chairman **Roth**. Please be seated. Mr. Johnson, you have, I know, a prepared statement. You can either summarize it or read it. If you summarize it, it will be incorporated in the record as if read.

TESTIMONY OF PHILIP JOHNSON, CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION; ACCOMPANIED BY: JOHN COTTON, DEPUTY DIRECTOR, DIVISION OF ENFORCEMENT; THOMAS LOUGHRAN, DIRECTOR OF THE DIVISION OF ENFORCEMENT; JOHN MANLEY, DIRECTOR, DIVISION OF TRADING AND MARKETS; DENNIS DUTTERER, GENERAL COUNSEL; AND JAMES STONE, COMMISSIONER

Mr. **Johnson**. Thank you very much, Mr. Chairman. Before I begin, I would like to have the opportunity to introduce to the Chairman the members of the staff with me this morning.

On my far left is John Cotton, Deputy Director of our Division of Enforcement; Thomas Loughran, Director of the Division of Enforcement. On my immediate right is John Manley, Director of the Division of Trading and Markets. On my far right is Dennis Dutterer, our General Counsel. In the audience as well this morning, Mr. Chairman, is another member of the Commission, James Stone.

Mr. Chairman, let me begin by congratulating you and the subcommittee for examining the area of so-called commodity frauds, which, in the main, are little more than garden variety confidence games. They are no part of the huge commodity futures industry which this Commission is charged by law to regulate. They are a breed apart, today's Jesse James, who steal not only the public's money, but the commodity industry's good name as well. They submit to no one's regulation, Federal or State, and will not be stopped until the iron gates of prison close behind them.

When the Commodity Futures Trading Commission was created in 1974, Congress did not intend or expect that the Commission would become the Nation's only sheriff available to arrest these criminals. Nor was the Congress naive enough to think that regulation, rather than convictions, would ever deter the lawless elements in this or any other area. Rather, the Commission was formed to assure honesty within the organized commodity exchanges, where honor is the rule rather than the exception, and where regulation is a meaningful and effective tool. Our society deals differently with outlaws and bandits, because it must.

The point that I have just made is often overlooked. But it is an extremely important one. For that reason, I sent a letter last summer to the attorney general of every State urging that they take a greater interest in phony commodity scams. I pointed out that the CFTC did not stand in the way of State prosecutions of these frauds, and, in fact, would be pleased to assist them.

I also pointed out that, if there had ever been any doubt in that regard, Congress had made clear in 1978—nearly 4 years ago—that the States can sue in their own State courts to enforce their own general antifraud statutes, civil as well as criminal, to this end. Or, if the States wish, they could bring suit under the Federal act and we would be happy to participate.

This Commission has extended similar invitations to the Justice Department, the FBI and the Federal Trade Commission. We have also provided seminars and training, as well as coordinated information, and referred cases to the Internal Revenue Service.

Recently, the Commission prepared and published a booklet entitled "A Spotter's Guide to Commodity Investment Frauds," and circulated it to scores of State law enforcement agencies. To our knowledge, it is the first and only primer setting forth the telltale signs of these fraudulent enterprises so that they can be detected at an early stage, before real damage is done.

The Commission added new State officials to its advisory committee on State jurisdiction and responsibilities in the hope of enhancing Federal/State coordination in this area.

The Commission is preparing a 2-day seminar for the benefit of State law enforcement officials, to be held shortly, to acquaint them with these frauds and to help them to prepare successful cases.

The Commission has made legislative recommendations which are contained in two pending bills, H.R. 5447 and S. 2109, to add even more weaponry to the arsenals of Federal and State agencies in the fight against off-exchange con games. One proposal would allow those agencies to use any law or regulation at their disposal to eradicate this problem. Another would assure them access to any information in the Commission's possession that may aid them in their efforts. We are urging the Congress to adopt both of those measures.

[At this point, Senator Rudman entered the hearing room.]

Mr. JOHNSON. I am deeply troubled that these steps, to which both I and the staff of the Commission have devoted great effort, should be brushed aside by some as mere "lip service." If our efforts to date have met with indifference or even hostility, the fault lies elsewhere than with the Commission. Meanwhile, we remain committed to this campaign, in all its facets, and we have no intention of despairing.

Despite the fact that the futures industry, where our attention must necessarily be focused, has virtually tripled in the last 5 years; despite the fact that we must monitor dozens of new futures contracts not even in existence a few years ago; and despite a real reduction in our true spending power over that period; the Commission devoted more than 20 percent of its enforcement budget in the last 3 years alone to attacking the off-exchange confidence games. Those resources have been used to bring 36 lawsuits against over 100 of these off-exchange boilerrooms, resulting in 255 injunctions, the recapture of approximately $3,500,000 of customer funds and criminal prosecutions against 19 individuals including all—I repeat all—of the swindlers who have testified before this subcommittee. Imagine the results that could be achieved if every Federal and State agency were to make a similar commitment. That is the objective of all of our recent efforts.

It has been said that the Commission does not have the resources to stop all of the off-exchange frauds. That is not only true, it is obvious. But we have made as great, if not greater, effort in this area than any other agency, pound for pound. Mr. Chairman, I hope that this fact will not be overlooked in these proceedings.

We also hope that these hearings, which have provided so valuable a focus on criminal behavior in phony "commodity" firms, will not be distracted by the pleas of certain State securities administrators that this subcommittee carry their banner as they attempt to gain control over commodity pools that are already regulated at the Federal level. Commodity pools as a class are not synonymous with the species of criminal highlighted by these proceedings. In fact, commodity pools have been established by some of the Nation's most reputable brokerage firms like Merrill Lynch, E. F. Hutton and Bache, and have been reviewed at both the Commission and the SEC.

Instead of consuming State resources to process a second or third time the papers of legitimate commodity pools, most of which have already been scrutinized at the Federal level, we feel that those funds should be targeted against the charlatans who plot, from their first day, to fleece the public of its savings. The possible future role of State securities commissioners in the commodity pool area will be considered during the Commission's reauthorization hearings which are now pending in the Agriculture Committees. And the Commission will address there whether it is sound national policy or consistent with the concept of "New Federalism" to introduce 50 potentially inconsistent and conflicting sets of local standards, with substantially higher cost, to a process that is now centralized and uniform.

My point, in this presentation, is simply that such a role is not as compellingly needed as the help of the States in the off-exchange scam area and that, since State resources are already scare, those reources should be concentrated against the off-exchange boilerrooms.

It has also been said that the Commission's new pilot program in options, approved last September and scheduled to begin this summer, will provide boilerrooms with a new opportunity to bilk the public. Those who are familiar with the pilot program would strongly disagree. Under that plan, only Futures Commission Merchants who are registered with the Commission and who are members of a licensed exchange may sell these options, and all options will be traded strictly on the exchanges. Extensive sales practice requirements will also apply. This program has been found adequate not only by the Commission, but has been reviewed by two congressional committees.

In the event that illegitimate firms pretend to be a part of the pilot program, these hearings and my testimony today should help to alert the public to that lie. But it does not follow that the pilot program itself should be scuttled. When a new factory comes to town, and a brothel opens across the street, no one would suggest that the solution is to close the factory. As a previous witness, Mr.

Latham indicated, these scam artists sell fraud, not commodities, and hobbling the legitimate industry is no answer.

There has been testimony that the Commission's registration procedures do not screen out the criminal elements. The registration requirements of the Commission already include name checks with other law enforcement agencies, most notably the SEC, the Secret Service, and the FBI. The swindlers who have testified here, and who obtained registration with the Commission, underwent those checks, and the Nation's most comprehensive criminal information agencies, including the FBI, reported no adverse findings.

Beginning this summer, fingerprint checks will also be made. And our current legislative proposals will extend the registration requirement to most principals and key personnel of all commodity organizations. These steps will augment existing screening procedures which have already been effective in blocking over 1,200 applicants from participation in the commodity industry, including a "star" witness here, Kenneth Levin.

Chairman ROTH. If I could just interrupt you there, are you aware that Kenneth Levin's wife is registered?

Mr. JOHNSON. No; I was not aware of that, Mr. Chairman.

Chairman ROTH. Our staff have talked to her. She said she couldn't tell us details because "Kenny takes care of the business." So I think there are some problems with registration, but please proceed. Apparently she was registered up to 1979. Please proceed.

Mr. JOHNSON. I understand that the Commission's reparations program has been heavily criticized. No more so, I assure you, than it has been within the Commission itself. When the program was conceived in 1974, the assumption appears to have been that reparations in this area would be as easy to administer as the USDA's system, after which our program was patterned, but which involves rather simple issues such as whether spoiled or underweight produce has been sold.

Instead, the Commission must grapple with the same types of complex legal issues that have strained the dockets of the 95 Federal district courts and 600 Federal judges. These issues are: fraud, deceit, manipulation, and churning, among others. Over 4,000 of these cases have been filed with the Commission, and have swamped our four judges and one presiding officer. Frequently, the offender is in bankruptcy and, in those cases, the Commission is required by law not to proceed. Many other offenders are in receivership, where proceedings would interfere with the receiver's efforts to marshal assets for the benefit of all customers. And, of course, some offenders simply disappear and cannot be served with the complaint.

The result has been a substantial backlog of reparations cases at the Commission. Steps have been taken in recent months, however, to ameliorate that problem. Case tracking is being computerized, so that parties can receive current and accurate reports on the status of their cases. The reparations office has been reorganized so that all functions prior to the hearing stage are centralized. We are in the process of hiring another administrative law judge. Some progress is being made.

But those steps are not enough. What is needed is a "fresh look" at the entire reparations program. For that purpose, we have recommended to the Congress that the old blueprint, now etched in the statute, be removed and that the Commission be allowed to redesign the program in a simple but equally fair way. We are also proposing to narrow the program somewhat so as to eliminate those classes of cases with the highest rate of worthless and uncollectable awards. We are confident that, with these changes as well as further internal improvements, this chapter of the reparations program's history can be closed forever.

Let me conclude by praising the subcommittee, once again, for its valuable contribution to the public's understanding of the off-exchange scam problem. The solution lies in greater public awareness, and in a firmer resolve by all Federal and State agencies to build upon the efforts that the Commission has made in this area.

The response to date has been inadequate, not for lack of the Commission's trying, but because of disappointing results from our efforts to rally support. If the States, for instance, were to take greater advantage of their existing powers under local fraud laws, if they would exercise their right to use our own statute and would petition their own legislatures whenever local laws restrict them from doing so, and if they will support and make use of the expanded authority that we propose in our pending legislation, the problem can and will be brought under control. But we cannot lead without a following, and no one can replace us as the leader until there exists a firm and unbending resolve to try.

Mr. Chairman, I request permission to submit for the record an important supplemental statement chronicling the Commission's recent efforts to involve other law enforcement agencies in our campaign, and some of the problems that we have encountered.[1].

Mr. JOHNSON. Thank you very much.

Chairman ROTH. Thank you, Mr. Chairman. Let me start out by saying that, first, I agree with you that most of the industry are legitimate, law-abiding individuals, and concerned. The problem, as always, are those, the few, the exceptions, who do not comply with the standard of conduct that I think is essential in this kind of an industry.

I want to congratulate you for your stated interest in pursuing new procedures and remedies to insure that this industry is characterized by the highest standards of ethics and honesty.

On the down side, I have to say that I am greatly concerned about the amount of fraud and situations that have arisen where innocent people have been exploited and conned. We have heard a great deal, Mr. Johnson, in testimony this week about the continuing extent of schemes designed to defraud the public. It has been estimated that these amounted to something like $200 million a year. So, no one can argue or contend that it is not a significant factor, particularly when you read some of the cases and know the tragedy it has created in many families.

So, I take it from your testimony that there is, indeed, a serious problem in this area. I applaud your support for increased authority for the States' securities commissions because I believe that time has shown that CFTC is simply unable to do the job on its own.

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[1] See p. 239 for the supplemental statement of Philip McBride Johnson.

Frankly, it is a shame that Congress didn't recognize this fact in 1978.

I have to say that I am not sure I agree the Commission in the past—I realize you are a new member—I am not certain I agree the Commission has in the past been that helpful in enlisting the assistance of State authorities or, for that matter, U.S. attorneys.

So, my first question in this whole area is, Do you really believe the Commission's proposal goes far enough? Don't you believe that a tremendous problem has developed in the area of fraud by commodity trading advisers, and commodity pool operators?

It appears to us that many, if not most, of the recent cases have involved persons actually registered with the CFTC in some capacity. As a matter of fact, one of my concerns is that sometimes registration appears to be a shield, that the illegal operators are using their so-called registrations to legitimatize their illegal operations and are taking in innocent people.

So, I am concerned. As I say, I applaud and appreciate that you go as far as you do, but I must say in all candor, I have serious reservations that you don't go far enough.

Mr. JOHNSON. Mr. Chairman, the proposals that we have made to the Congress in the course of the reauthorization proceedings that are underway are a major step in the right direction. We pulled up short of authorizing regulations at the State level by States' securities administrators for a variety of reasons.

The first is that the tools needed to remove the problem of off-exchange scams are in the courts and not in the administrative agencies. We do want the attorneys general of the States and the U.S. attorneys' offices and the criminal prosecutors throughout the Nation to be more actively involved in this, but we have a workable and, I believe, effective system of registration and surveillance with respect to commodity pool operators and commodity trading advisers.

By saying that, I don't mean to suggest for a moment we don't have problems in that area. If there were no problems, there would be no need for any of the programs we do have in these areas. But our experience to date in the commodity pool area, for example, is that of the over 800 commodity pools that we have registered, we have had to take action for fraud against barely 1 percent of them. There may be others out there, and we certainly monitor them closely, but our experience has not been of the dimension of the problem that is encountered in the case of the off-exchange scam.

Our view is that it would be very much to the advantage of the eradication of that problem not to have resources diverted into the filing and review and paper processing of firms like Merrill Lynch and E. F. Hutton or Bache, or a large variety of other highly respected firms that sponsor these people.

So we are concerned that an attempt to move into that area now would constitute a diversion of resources from the principal area of the problem.

I understand and I fully appreciate that registration with any agency, Federal or State, does, in fact, suggest to the public that there is an imprimatur. We have in our regulations a requirement that the registration never be used for that purpose, but in the environment, and among the group that we are referring to in these hearings, those regulations are simply ignored, as they really ignore any regulation that might stand in their way.

We did have a hotline for a while. It was discontinued by Commissioner Stone when he was chairman because there was a tendency to leave the public with the impression that an answer yes to the question would, in fact, infer an endorsement on our part.

It is an unfortunate side effect of registration, but the benefits of registration generally far outweigh that, in my judgment.

Chairman ROTH. I guess one of my concerns is that looking at the size of your Commission, I, frankly, find it rather difficult to believe that with six auditors you can monitor 800 pools very closely. It seems to me that this problem of duplication which you allude to of States adding additional requirements to that of the Federal is a question I want to explore much more carefully.

You make some reference to federalism, which will be a matter this subcommittee will be primarily concerned with. Nevertheless, we do have the same thing in SEC where you still have your blue-sky laws. So that I don't say duplication in this area is necessarily bad, but we have had a number of security commissioners before us. They had some pretty compelling testimony regarding their fears of what may happen in the illegal market as a result of the proliferation of contracts.

Complaints we have heard involve the CFTC decision to market options and the decision to allow trading in the stock index futures contract. I want to make clear I am not an expert in this area, but I wonder if you could explain what is the economic and social purpose of an option or the stock index future? And do you share the fears expressed by State administrators that these developments will be utilized to the advantage of unscrupulous promoters?

I might say, as one who has been very interested in trying to help capital formation as part of our economic recovery, I wonder to what extent these new types of contracts will drain our capital that might be used elsewhere?

Mr. JOHNSON. Let me begin by discussing options for a moment. The fundamental focus of the Commission is on the development in trading of instruments which provide an opportunity for price hedging; that is, for price protection against adverse price changes, and for price discovery; that is, projection or forecasting of the future value of items.

A futures contract, which has been a traditional vehicle for achieving both of those objectives, is a valuable hedging tool and a valuable price discovery mechanism. However, it has one significant disadvantage to the commercial user. If the price of the item moves adverse to that particular firm's commercial activities, then the profits derived from trading in the futures market help to cushion the loss it sustained in the commercial transaction.

But the inverse is equally true. If the price moves in the opposite direction, that firm is faced with the obligation to absorb all of the losses incurred in the futures market which will usually pretty well offset the gains in the commercial transaction that is being priced in the same direction.

An option has an advantage over that in that it provides full downside risk, but at the same time limits the risk of sustaining losses because an option, unlike a futures contract, can be allowed to lapse, at which point all that is lost is the premium paid for the purchase of the option in the first place.

The Commission has taken an interest in this area precisely because options do, in that context, provide what may be a more valuable price protection mechanism than a futures contract.

Our pilot program, which is experimental, which is limited to 3 years, which is confined to registered people and exchange members and which will be confined entirely to exchange activity, is intended to test whether it is, in fact, the better vehicle for the protection of businessmen in their commercial transactions than the futures contract.

As far as stock index futures are concerned, there are something in excess of $1 trillion of Americans' money invested in the stock market. There are roughly 30 million investors in the United States. At this time, according to our economic analysis, there is no economical way for those savings, which are invested in securities, to be protected against downside price risks except at extraordinary expense.

The futures contracts we have been regulating in the agricultural area, in the area of interest rates, in the area of hard goods have provided an opportunity for the owners of very valuable assets to protect themselves against a depreciation in that value.

The stock index futures contracts are intended to bring the same services to the securities business which is currently not available except at very substantial cost. That is the reason why the stock index futures contract was approved. We expect that as the contracts become more familiar to the securities industry that large portfolio managers, mutual funds, large pensions and insurance companies, if regulatory obstacles are removed, will all find that the best service they could provide to those who entrust their money to these organizations is to have a method, and the stock index futures contract is one, to protect against watching the savings that these people have invested eroded by a downturn in the stock market or a general downturn in the economy. That is the reason why we have proceeded into this area, and we feel that it will provide for the average American citizen, and there are 30 million of them, a better opportunity than they have at present to protect their savings through this vehicle.

As far as the matter of whether the expansion of these areas could result in an emergence of new forms of fraud, I think that one has to realistically expect that wherever there is growth and wherever there is success, there will be the criminal element operating in the shadowy crevices around it.

As I indicated in my prepared remarks, that is an enforcement problem. I do not know of any industry that has ever been successful that hasn't generated a few of these fellows, and I don't suspect we are going to escape that either, but our view is that the emergence of these vehicles is valuable, that it will, in fact, aid the economy and that we will simply have to deal with the rabble-rousing edge in the way that we always deal with that element.

With respect to the question of whether or not capital formation may be impaired, we have researched and studied all of the literature on the subject. We have conducted inquiries, both alone and in conjunction with the Treasury Department and the Fed, in the area of interest rate futures to determine whether there might be any erosion of interest in trading underlying debt securities.

The wealth of literature on the subject indicates that that has not been the effect. That, in fact, the availability of these kind of instruments actually allows people from time to time to make bigger commitments because of the downside protection afforded by the futures market than they would otherwise dare make.

We feel that in the stock index area, the same experience is likely to occur. It is brand new. I can't promise you that it will, but it hasn't failed us yet. I have every confidence that, if anything, it will make investing in securities more attractive than would be the case if one were required to take, as one is now, a purely naked position in the securities market.

Chairman ROTH. I guess my problem is that, to go back to your earlier statement, I am not persuaded, at least at this stage, that we are creating a factory as you say. The subcommittee is aware of a long history of fraud in the marketing of commodity options.

For example, our ranking Member, Senator Eagleton, in 1978, said in an Appropriations Committee hearing:

> Would the vitals of democracy be violated if we outlawed options? What worthwhile humanitarian civilized purpose do options serve if they are subject to manipulation? Democracy won't crumble without them.

During the same hearing, Senator Bellmon said:

> Why sit around and wait until we have a scandal before we do something? I agree with our chairman, if you can't properly regulate options, I say put them out of business until you can. If you sit around and wait and forward contracting, we are going to have real problems on our hands, it seems to me.

I guess my concern is we are opening up a recurrence of the problems of the past. This seems to me particularly serious when admittedly you don't have adequate staffing to enforce what you already have before you, so I am just not clear how you are going to avoid future problems with the kind we suffered in the past.

Was the Commission unanimous in opening these up?

Mr. JOHNSON. The vote was four yes and one present.

Chairman ROTH. I don't think there is any question anyone would argue, yourself included, that current enforcement is not adequate. Would you agree or disagree with that?

Mr. JOHNSON. Mr. Chairman, I draw a distinction. I think that our enforcement capability is adequate to police the marketplaces which are at the center of our charge, and the options program that we have been discussing is, in fact, an exchange traded program. Where we run into problems and where we will readily admit inadequate resources is when we must reach out into the areas that this subcommittee has been examining, to those who operate not within the industry but as pretenders to be in the industry.

Chairman ROTH. Let me ask you this. Given the huge past problems with options, would you be willing to give States concurrent jurisdiction over this area?

Mr. JOHNSON. Mr. Chairman, all of the options we have authorized in recent months will be traded entirely on the licensed commodity exchanges. There will be no private vending of these options. Congress has never recommended that the regulation of the exchanges, as such, be diffused among the various States, and I think we can all appreciate the difficulties that exchange trading would encounter if compliance with the potentially 50 different——

Chairman Roth. We do that in many areas. Insurance companies are regulated by 50 different States, so that is not peculiar. I know the industry itself never likes it. It depends. The insurance companies don't want us to bring it to Washington, so I don't think that the argument that there are 50 different States is the critical or most relevant question, but I gather from what you are saying you would not recommend concurrent jurisdiction in this area; is that correct?

Mr. Johnson. I am sorry, Mr. Chairman.

Chairman Roth. Your answer is in the negative to my basic question, you would not give concurrent jurisdiction with respect to options?

Mr. Johnson. Not to exchange-traded options, Mr. Chairman. There are only 11 exchanges in the United States, and we regulate them ourselves. If they were off-exchange options trading which, in fact, is banned by law at this point, we would have no objection whatsoever to having the States involve themselves in that area.

Chairman Roth. One of my concerns is, as you well know, I think there, in the past, have been some turf battles. Very candidly, I don't think the Commodity Futures Trading Commission has a history of being that cooperative. I am not talking about your chairmanship or stewardship; I am talking about the past.

Would either the States or, for that matter, the SEC—I wonder, can you tell me briefly whether commodity regulation should differ so radically from security regulation? You look at the role played by the States on the security side with blue-sky and other laws, why should it be different with respect to commodities?

One further question in this area is, Might it not make good sense to consolidate this agency with SEC? That would certainly avoid turf wars between the two, and you would be marshaling much broader resources for a charge that while not totally alike, is not that unlike?

One of the things that we will be concerning ourselves with is the reorganization of the Federal Government down the road. I wonder why it might not make some sense to consolidate this Commission with the SEC.

Mr. Johnson. Let me begin by addressing the differences and, in large measure, the lack of differences between securities regulation and commodities regulation.

At the fundamental core of public protection, the systems are really quite similar. Both the Securities and Exchange Commission, for which I have the very highest respect, and the Commission prohibit and enforce requirements against fraud, market manipulation, cheating, deception, the core of the type of activity that most frequently and most directly impact on the investing or trading public.

There are differences between the two systems. I would like to, if I may, mention several of them.

On the commodity side, we have the requirement that no futures contract will be approved unless it can be shown to serve an economic purpose, which means either a hedging function or a price discovery function.

The Securities and Exchange Commission does not approach securities issuers in that fashion, but simply asks that the nature of the investment be fully disclosed. It may or may not have any hedging function. It may or may not have any price discovery function, but it will be approved by the SEC if full disclosure is made.

We have a requirement that all customer funds be fully segregated. There is no counterpart in securities regulation. We have in the commodities area price limits on daily fluctuations of market prices. There is no equivalent in the securities area. We have speculative position limits to restrain excessive speculation. There are none in the securities area. We have a clearinghouse guarantee system so that no customer must rely upon the credit worthiness of the party on the other side but can look to the clearing organization to insure the fulfillment of his contract. There is no equivalent protection in the securities area.

We have a variety of other requirements that have no counterpart in the securities area.

In one area that I heard much discussion of, the SEC has a special precaution. It has a suitability or know-your-customers rule. That is exceedingly valuable in the securities area. There are 30 million people out there who own securities. They are frequently sold securities on the basis that it is precisely the right thing to do to plan for their retirement or to educate their children. They have an enormous array of different kinds of securities from which to select. They have the most conservative blue chips to the so-called hot issues to the purely speculative. In that environment, dealing with many people from all walks of life and every economic stratum, it makes a great deal of sense to require that the broker familiarize himself very, very deeply with whom that stockholder or potential stockholder is and to be sure that the advice given, and I must emphasize that almost all these rules have to do with the rendering of recommendation, be sensitive to the individual circumstances of every investor.

In the commodities industry, there is no one, from the man on the street to the sophisticated individuals in this room today, who do not know that it is a short term, high risk, terribly dangerous thing to do, particularly with one's own saving.

All futures contracts, generally, present that very same profile. As a result, my best estimate, and I won't say that it is 100-percent accurate, but it is in the ballpark, is that there probably are no more than about 100,000 people in the futures market who fall into the category of a public investor. These tend to be, based on our reparations experience and other profiles that have been made, doctors, dentists, lawyers, quite successful people, who, by and large, do not put their life savings into these markets, but put their discretionary income into it.

For that reason, we felt disincentives built into futures trading provided a screening system without the necessity of having the suitability or know-your-customer rule as in securities, and the statistics seem to bear that out. There is only one public participant in the futures market for roughly over 300 stockholders. So we have not gone to that; not that we can't, not that some day we will not, but the statistics indicate that we do not have the type of individual in the futures market who is being induced into the stock market.

As far as a merger between the Securities and Exchange Commission and our Commission is concerned, I sit here at somewhat a disadvantage because Chairman Shad of the SEC and I met throughout the fall, as you may know, and developed an agreement, which we both will be asking Congress to ratify, that will more clearly delineate the jurisdictional lines between the two agencies.

This agreement was reached after what you so correctly indicate, Mr. Chairman, was 8 years of virtually open warfare. If the agreement is endorsed and if the agreement is adopted, I think that the two agencies will be able to close the book on that kind of tension and contentions between them for at least a considerable period of time.

I do not know that the SEC has any interest in absorbing the Commodity Futures Trading Commission. I know the SEC would have quite a learning experience ahead of it if it were to try to take over the functions that the CFTC performs, particularly in the economic analysis and economic purpose area.

We do not favor a merger of the two agencies at this time. Our orientation and the products that we trade, ranging all the way from soybeans to Swiss francs, are, in many instances, items with which the SEC is not familiar.

Our view is that it remains necessary to have two agencies.

Chairman ROTH. I don't expect that question to be resolved here today. Of course, fundamentally, it is a question for Congress to decide. I would appreciate, and then I want to turn it over to you, Senator Rudman, for the purposes of the record, would you supply the number of commodity customers and how you arrive at that figure?

Senator Rudman, I want to express publicly my appreciation of your chairing the hearings yesterday as the vice chairman of this subcommittee, which I regrettably could not attend. I thought they were very useful and quite exhaustive. I want to publicly, as I say, express my appreciation. Senator Rudman.

Senator RUDMAN. Thank you very much, Mr. Chairman. Mr. Johnson, I have listened to your explanation why you have introduced your options pilot program and your answer to Chairman Roth in terms of the economic incentives it might offer.

Of course, you do make a good case, but I think you only make half of the case. Is it not true that over the last 36 months, the pressure on the CFTC to adopt this kind of a program has not come from consumers or institutional investors or anyone else who is interested in building hedges, but it has come from the industry itself which stands to make a huge amount of money through commissions, through the sale of new seats on their various exchanges; that this is another good marketing tool in which to make money.

There is nothing wrong with making money, but let's talk about where the pressure is coming from and who is pushing for this new product.

Mr. JOHNSON. Senator, I will be happy to answer that. If I might, I would like to give you a little historical background. The idea of trading options first emerged about 1976. In 1978 when the Congress reauthorized the CFTC, there were statements in some of the legislative history that the Commission should get on with the job, why was the options program still not activated.

Following that period and those types of statements, the Commission continued to examine options. I will say that in the very same period of time, the off-exchange London-type option scams had come to a head, and we had our hands full trying to take care of that problem. The staff continued to work on the questions of the efficacy of an options program. We wanted to be certain that we had a pilot program, and we had always thought in terms of a pilot or experimental program, that was done the right way.

All of that came to a head this past September when the staff finished its work, when some hard decisions were made, such as we decided we would not let anyone vend these options who was not only not registered with us, but also not a member of one of the sponsoring exchanges, that we would limit the program to 3 years, that we would impose special sales practice requirements in the area, and put a great deal more burden on the exchanges in terms of self-regulatory responsibility.

The program has actually been in a germinal state for almost 6 years and, in 1978, we were chided by the Congress for not having done anything up to that point. I regret we were not even more responsive after that.

Senator RUDMAN. The fact of the matter is various exchanges, including the one you represented, and that is a matter of public record; you have a very distinguished career and are very qualified for the position you now hold, the fact is when you represented the Chicago Board of Trade, U.S. Counsel to the Chicago Board of Trade, you developed some of the contracts submitted to the Commission for approval. That is perfectly proper. I am not criticizing that, but the thrust for these new kinds of selling contracts came from the Chicago Board of Trade and their motivation is the more contracts they get out there, the more ways people can invest and speculate, the more commissions, the more profit for the members of the Chicago Board of Trade; correct or incorrect?

Mr. JOHNSON. There is no question about that. It is a new product and, therefore, valuable.

Senator RUDMAN. Having said that, on the first of June, 1981, Mr. Loughran, who I believe is sitting to your left, who is the head of your Division of Enforcement, sent a memorandum to the Commission. This is your own Enforcement Division, and let me just read parts of it for the record. It is entitled a "Confidential Memorandum," which, of course, in Washington doesn't mean anything at all. It is to the Commission, dated June 1, subject, "Options Pilot Program," and it says:

> The Commission will consider the options pilot program in an open meeting on June 2, 1981. The Division of Enforcement believes that a Commission decision to go forward with any options program may have a substantial adverse effect on the Commission's ability to enforce the Commodity Exchange Act and the Commission's regulations. This adverse effect might be mitigated by adoption of certain safeguards which, unfortunately, are not included in the present proposal and, to our knowledge, have not yet been given the close consideration they warrant.

Then they go on to describe the probable effect of the options and major deficiencies. Here are the major deficiencies cited by Mr. Loughran at that time:

> The options package as currently structured has two obvious deficiencies. The first is a lack of any real requirement for an automated transaction audit trail at each licensed exchange. Without a transaction reporting system which provides adequate market reconstruction capability, it will be virtually impossible for the exchanges to design trading surveillance systems to detect the forms of manipulative activities,

et cetera.

> Second, there is no general requirement imposed upon member firms to ensure that only the right players participate in the game, and without account opening rules which require sufficient information about a potential customer to allow the firm to determine whether a particular customer can understand and bear the risk of transactions to be recommended . . .

The conclusion was that:

> In making any decisions concerning an options program, this Commission should be mindful of both the troublesome history of commodity options and also the difficulties encountered by the SEC in regulating its markets for security options exchanges,

and so forth and so on.

My question to Mr. Loughran is simply, were either of the recommendations that were embodied in your June 1 memorandum to the Commisison adopted and now part of the pilot program?

Mr. LOUGHRAN. Senator, neither of the recommendations was adopted totally. I can say that the Commission was responsive to my concerns about suitability, perhaps not as responsive as I might have liked, but I will say responsive to the duties which suitability and attendant recordkeeping rules generally impose.

The Commission came up with a unique experiment in the form of a disclosure rule and recordkeeping rules which I hope will be effective. I cannot predict what the future holds.

Senator RUDMAN. Mr. Loughran, do you still hold your reservations about this pilot program as Chief of the Enforcement Division?

Mr. LOUGHRAN. Sir, I have to hold my reservations about it. I always have to. Any new product concerns me, and I have to, Senator.

Senator RUDMAN. Mr. Johnson, could you tell me why the two recommendations as set forth in this memorandum were not, just as a matter of general prudence, adopted and put into effect?

Mr. JOHNSON. The audit trail concerns that Mr. Loughran has indicated relate primarily, if I understand it—the memorandum was prepared before I arrived at the Commission—to the valuable information that might be supplied if we had a trade sequencing system available to us.

The Commission did give very close consideration to the question of developing a special trade sequencing system in this area. By that, I mean a system by which one could time the particular period of execution of a transaction.

The commodity markets operate and they are physically structured in such a way that the existing technology to achieve that did not exist at that time. Some estimates were received as to what it might cost per exchange to put such a system into effect, and even under those circumstances, it was in the millions of dollars and would require some substantial restructuring of the manner in which trading occurred.

In other words, while we do have sequencing now to the nearest half hour of the trading day in which the transaction is made, to telescope it down into a shorter period of time would have required major technological changes which we felt would not be warranted in a pilot program which we had limited by law to a 3-year period which would have involved a very substantial commitment of capital by each of the exchanges and major changes in their trading patterns.

With respect to the question of suitability or know-your-customer, Mr. Loughran touched upon the step we did take which we feel is a major step forward in the options area. And that is, we did place an affirmative duty on every broker to acquaint himself sufficiently with the personal circumstances of each new customer upon opening an account to be able to make a determination as to what level of disclosure, including warning him off, would be appropriate.

There is no counterpart to that in the futures regulation, a specific counterpart. So a step was made in the direction of satisfying Mr. Loughran's concerns.

Senator **Rudman**. Let me simply say to you, your statistics, I am sure, are accurate in terms of the people who get involved in this kind of trading. But there is reason to believe that there are people in this country, and we had some who testified before us over the last 2 days, who truly need to be protected from themselves. That is the reason that suitability requirements, as you are well aware from your very distinguished career in the law, there are a number of securities that require various kinds of suitability tests to be melt in order to insulate all from liability.

[At this point, Senator Roth withdrew from the hearing room.]

Senator **Rudman**. It just seems to me that to be absolutely sure we don't have people victimized who ought not be victimized that you ought to pay some attention in the future to some suitability rule which would not be that difficult to administer.

I will ask that this June 1 memorandum be placed in the record at this point and made a permanent part of the record.

[The document referred to was marked "Exhibit No. 8," for reference and follows:]

EXHIBIT NO. 8

CONFIDENTIAL MEMORANDUM

June 1, 1981

TO: The Commission

FROM: Division of Enforcement

RE: Options Pilot Program

The Commission will consider the options pilot program at an open meeting on June 2, 1981. The Division of Enforcement believes that a Commission decision to go forward with any options program may have a substantial adverse effect on the Commission's ability to enforce the Commodity Exchange Act and the Commission's Regulations. This adverse effect might be mitigated by adoption of certain safeguards which, unfortunately, are not included in the present proposal and, to our knowledge, have not yet been given the close consideration they warrant.

Probable Effects on Sale of Illegal Options

The Commission should realize that any lifting of the options ban will most likely increase the activity of persons selling illegal options and thus the burden on the Commission's enforcement program. The Division anticipates that the options pilot program will serve as both a guise and an advertising ploy for unscrupulous operators who are in fact selling illegal options. Particularly in those areas of the country where off-exchange instrument sales have been so troublesome, unscrupulous operators will misrepresent the nature of the Commission's program and seek to foist their unlawful instruments upon the unsuspecting public as "exchange-traded options". While any pilot program may result in an increase of such unlawful activity, the Commission may be able to mitigate the effects of such a program by restricting the program to a limited number of futures contracts and making clear in all public releases and statements the very limited scope and experimental nature of the pilot program.

Major Deficiencies in the Current Proposal for Sale of Legitimate Options

The options package as currently structured has two obvious deficiencies. The first is the lack of any real requirement for an automated transaction audit trail at each licensed exchange. Without a transaction reporting system which provides adequate market reconstruction capability, it will be virtually impossible for the exchanges to design trading surveillance systems to detect the forms of manipulative activities (especially reporting of non-existent transactions) which were encountered in the securities options markets. Moreover, any such violative conduct which may be detected will be very difficult to prove absent an audit trail. Second, there is no general requirement imposed upon member firms to ensure that only the right players participate in the game. Without some form of suitability rule and without account opening rules which require sufficient information about a potential customer to allow the firm to determine whether a particular customer can understand and bear the risk of transactions to be recommended, supervisors and compliance personnel within firms will have neither the incentive nor the ability to control the activity of salespeople. The SEC's Options Study found that the lack of these types of control procedures at the firm level was the primary cause of customer abuses which appeared in the securities options markets.

The absence of audit trail and suitability requirements undermines self-regulation of the options industry at both the exchange level and also the member firm level. Where, as here, self-regulatory controls are deficient, it is not unreasonable to expect that public customers and the integrity of the marketplace will suffer from the resulting abuses and, consequently, a large, and perhaps overwhelming, enforcement burden will fall upon this Commission.

Conclusion

In making any decisions concerning an options program, this Commission should be mindful of both the troublesome history of commodity options and also the difficulties encountered by the SEC in regulating its markets for securities options exchanges. We are not aware that the wealth of information and analysis generated by the SEC's Options Study has yet been fully assimilated by this Commission and its staff.

What is needed is a careful analysis of all this information and a free discussion among the staff and the Commission of the merits of alternative proposals. Only in this manner will the Commission be in a position to act responsibly and on the basis of all available information to design the most effective and efficient regulatory package for options trading. Of course, such a regulatory package is in the best interest of all the public, including the options industry and the public options customer. Finally, Congress and the public expect and deserve the Commission to propose and adopt the best regulatory program available and the Commission should act carefully to meet these expectations.

T.J. Loughran X49501

Senator RUDMAN. I think there is a great deal more that could be said about the whole reason behind the introduction of this programing. My own view is, if you pardon me for saying it, sir, I really think this is essentially not much different from a national lottery. I am now talking about the value line index that the Kansas City Board of Trade is not going to be using, New York Stock Exchange Composite, Standard & Poors, the 500. I am sure there are a few people in this country who will make some money with that. I think there will be a lot more who will lose it. I suspect we will never know.

Let me turn to your statement on page 2 in which you speak of your willingness to cooperate with State agencies. Of course, the statement is very carefully drafted. What you are essentially saying is that the States can sue in their own States courts to enforce their own general antifraud statutes, civil and criminal, or you point out they could go forth in Federal court under Federal statutes.

Mr. Johnson, I don't really understand your reluctance to develop legislation with the Congress that would not allow, if you will, joint regulation of this industry because I think you make a valid point about regulation of this industry maybe being better centralized, but I see no reason whatsoever why the attorneys general of the States of New York or California, New Mexico, New Hampshire, Delaware, wherever, who have the ability to prosecute fraud in this area under their own securities statutes in their own State courts—after all, they are presently prosecuting a whole myriad, if you will, of fraud in land sales, in condominium sales, in development schemes, and they are quite sophisticated, and they have big staffs and investigators and auditors—why not have shared jurisdiction in the area of criminal prosecution in terms of their securities acts? Why not do that and why not bring all of the forces to bear against that element, admittedly small, which is giving this industry a bad name?

[At this point, Senator Roth entered the hearing room.]

Mr. JOHNSON. Senator, let me respond in this way. At the present time, as you point out, the States have full authority to proceed under their general antifraud statutes, including all of their criminal general antifraud statutes. We certainly do not stand in the way of doing that.

They have said from time to time that in some ephemeral way, that we impede their efforts, and that is simply not true. We have a proposal now pending in both the House and the Senate to allow the States to use all of their laws, including their securities statutes, against the off-exchange scam as well as against any entity that should be registered with our Commission and that fails or refuses to do so. In that respect, we are moving very close to the objective that you outlined a moment ago.

Our concern is, and I will provide as much detail as you would like, that it is not necessary and, in our judgment, is not even desirable to require commodity professionals, the likes of Merrill Lynch or others, to have to knock on the door at 50 States in order to be authorized to conduct business in those States.

We have had experiences where those very firms have gone to particular States and asked to be authorized to do business and have been turned away, perfunctorily turned away. We are aware of the fact that certain States operate under a set of officially unapproved guidelines resulting from a series of meetings among securities administrators and their counterparts which have resulted in the development of requirements that no State legislature, no Governor, no one has ever approved and which are then used at the State level in a hip-pocket manner to foreclose legitimate firms from operating.

That is the area of our concern, Senator, rather than the criminal prosecution area.

Senator RUDMAN. If that is your area of concern, I think we can probably work something out, because I think what we are trying to do her and I know what the chairman has in mind and I share his view, is to make sure that we don't do anything at the Federal level to inhibit prosecution, investigation of those who violate State and Federal laws.

Finally, Mr. Chairman, if I may have just one more moment, I want to just ask one further question in a third area.

We had testimony yesterday and the day before concerning the reparations process, and one of the stories that was told, in fact, essentially the same story was told twice, was that your agency had essentially dismissed, without prejudice, a claim brought by one of those who had been defrauded because the securities dealer, and that may be a dignified name for the organization, although registered had moved to a new address, therefore, could not be served, therefore, the case was dismissed.

Don't you have normal service of process rules and regulations that would obviate that rather catch-22 result?

Mr. JOHNSON. Well, in this particular situation, Senator, the complaint was returned "No addressee." The organization, although it was reported to us, had moved, had, in fact, closed down and disappeared.

We do need to get service, as you are aware, in order to perfect personal jurisdiction. In that particular instance, the most regrettable aspect of that for which I would be more than happy and intend to apologize to Mr. Washington, as well as to Mr. Reuss, is that someone had presumed that a default judgment would ultimately be rendered in their favor, not knowing or not having checked the records to determine that service had not been made.

We are establishing now a case tracking system by computer which will allow us to call up on a screen the progress and status of every case and will prevent a recurrence of that type of problem. Our statute provides that we must make service—we, the Commission—must make service rather than the party. When a complaint goes out and we send them out by registered mail and it bounces back to us, and we have no forwarding address and no indication of how to perfect service——

Senator RUDMAN. May I simply inquire as to why you don't do what most of the States do, what all the States do in their dealing with corporations who are registered—foreign corporations—why you don't simply have a process developed like all of the States have for service on an agent as a requirement, prerequisite to being registered?

Mr. JOHNSON. I don't have an immediate answer to that, Senator. We are asking Congress to give us a clean slate to work with and that might very well be one of the improvements that ought to be made.

Senator RUDMAN. Obviously, what we did in our State, most States, if you have a foreign corporation registered and you want service on them, if you can't get them, you serve on their appointed agent.

As you know, there are many corporate services that supply this, and you simply serve them. It just seems to me to have a situation where somebody can register with you and then by disappearing avoid the impingement of the act has got to be a preposterous result for the U.S. Government to end up on the end of that kind of a stick.

I hope that you will give that some attention because the 50 States do it as a matter of course.

Thank you, Mr. Chairman.

Chairman ROTH. Mr. Chairman, on the first day of the hearings, we had a lady before us who testified that she lost her life savings and she said that before she got involved with this particular operator, she called your Commission to find out whether or not they were registered. She was advised, yes, that they were registered and in good standing.

Now, to the typical small investor, I think that would be very significant. I notice that in a number of ads in the Wall Street Journal of today, you have companies—this one is First National Monetary Corp. It has down there, "Registered commodity trading advisor, CFTC." There is another one in yesterday's paper, Wall Street Journal, Premax, "registered, Commodity Futures Trading Commission."

Why do you allow companies to tout registration when it really means very little and, in many cases, can mislead innocent investors?

Mr. JOHNSON. The granting of a registration at the Commission is not intended to be an endorsement. I appreciate that it is frequently perceived in that fashion.

Chairman ROTH. What should you do about it since that is a fact?

Mr. JOHNSON. Well, we have a regulation, as I referred earlier, that prohibits people from misusing that. We do not at this time preclude people from identifying the fact that they are registered. I believe firms in the securities business frequently do the very same thing in relation to their registration at the SEC.

Chairman ROTH. Is that registration investigation the same type as yours or is it more exhaustive?

Mr. JOHNSON. We have tried to follow the very same pattern the SEC does in our registration procedures, with the exception of the fingerprinting requirement which will take effect this summer. Excuse me, Mr. Chairman. We run the names through the SEC in our own registration procedure.

Chairman ROTH. I am not persuaded running it through the various agencies means that much. The small investor—and that is what we are concerned about—and I agree much with what you say, as the industry itself is concerned. Most of them are honest, law abiding, and trying to do the right thing, but you have those on the other side of the coin and they are your responsibility as well under the law.

It does bother me very much that the innocent person, and you can say "let the buyer beware" but I think that day is long past, you have this advertisement in the Wall Street Journal which says it is registered with you. It does make a lot people feel it is a responsible firm. I think this has to be dealt with. I am not sure what the answer at the moment is. I am not satisfied that the Commission is discharging its responsibility to the consumer.

I would like to raise a few questions with respect to the so-called leverage contract which I understand the Commission has ordered another 2-year study on. It is my further understanding that virtually every division in the Commission has already conducted a complete study of leverage contracts, so I wonder why it is necessary at this time to request a new, an additional 2-year study? Why can't the new Commissioners study the already existing studies?

For example, you are an expert in this area. You have written books in which you deal quite extensively with the question.

Mr. JOHNSON. Mr. Chairman, I think that is a fine point at which to start. The description that I have typically offered of the leverage contract, the only one with which I was familiar, based upon a 1976 study, I am told is no longer as accurate as it should be.

Most of the studies which were conducted within the Commission were conducted 2 or 3 years ago, if I am not mistaken, and I understand that the offerings of leverage dealers have changed rather significantly since that time. There is a more heavy emphasis on shorter term instruments than there was in the past. I for one do not have a familiarity with the 1982 offerings of a leverage dealer based upon some of the things I have heard lately, and neither do two of my other fellow Commissioners who are new to the Commission.

In any event the judgment was that it would be preferable to get an up-to-date and current reading on the leverage business and how it operates rather than to rely upon older studies.

We are concerned that we not take any action, either favorable or unfavorable, until we have a very clear, current picture of their operations.

Chairman ROTH. I can appreciate that there might be certain nuances, changes that you are not familiar with. Isn't it true that by the time you complete the 2-year study, you will be gone from the Commission? Commissioner Stone will be gone, Commissioner Gartner will have been replaced?

I find it very difficult to understand why an additional 2 years is needed when the four firms now in the leverage business will continue, I gather, to enjoy the monopoly they have had for several years.

I also take it that the Commission has no plans to enforce a comprehensive set of regulations, and if it is to take you another 2 years to do anything, wouldn't it be appropriate to allow the States to regulate these contracts?

Mr. JOHNSON. It is true that at least some of the members of the Commission are not likely to be here when the study is completed, but they will certainly have the full benefit of the study as it progresses.

Chairman ROTH. Why aren't the past studies adequate then? I don't follow.

Mr. JOHNSON. My understanding is the past studies are sort of period pieces, photographs of the nature of the industry at the particular times they were conducted, and that in more recent periods, the nature of the leverage business has begun to change. This is of critical importance in a particular area in that the——

Chairman ROTH. Particularly important to those four firms, I assume.

Mr. JOHNSON. We have asked for a moratorium, Mr. Chairman, on that because we certainly don't know how our final recommendation will come out, and we feel it would be unfortunate to admit more firms only to have them banned at the end of the study.

Chairman ROTH. I must say. It concerns me maybe there is some adequate reason for a 2-year study, but when three of the five Commissioners will be departing by that time, it looks like not much action will be taken.

I go back to the question I raised with respect to the question of the States. Why shouldn't the States have jurisdiction over these contracts? Are leverage contracts illegal under State bucketshop damage statutes because they are not traded on an exchange and there is no intent to deliver?

Mr. JOHNSON. I don't have an answer to that, Mr. Chairman. I am not sufficiently acquainted with State bucketshop laws. I know they vary quite a bit. I don't have an answer to that. I don't know of any State that has acted on one.

Chairman ROTH. Do any of your staff have information?

Mr. LOUGHRAN. No, sir.

Chairman ROTH. Mr. Chairman, our investigation has dealt almost strictly with off-exchange transactions, although we certainly have looked at trading advisors and the pool operators, to some extent.

What about the fraud problem on the exchanges? Isn't it true your Commission only has a handful of people to try to police that? How do you even manage to know what goes on in the so-called "pits"?

Mr. JOHNSON. It is not true we only have a handful of people. We concentrate the majority of our resources in that area. We have a variety of different units within the Commission, some of them small, some of them large, that focus in these areas.

We have dozens of employees who are concerned almost exclusively with the question of whether the market's operations are being conducted in an honest manner. So we do devote very substantial resources to that area.

Chairman ROTH. Senator Rudman.

Senator RUDMAN. I have just one last question, Mr. Johnson. This actually predates your stewardship by quite some time, but you are familiar with the case in New York, the *J. L. Love* case, and the case in Arkansas where the States' securities people went after a scam pool operator, and because of, I guess you would have to say, a turf battle going on, your Commission came in on the side of the pool operator to enjoin the State from getting involved. Are you familiar with that at all?

Mr. JOHNSON. I have read the case, Senator, and I think I understand the facts.

Senator RUDMAN. Would it be unreasonable to assume that if that happened again that your present general counsel would take a somewhat contrary legal view?

Mr. JOHNSON. It would depend, Senator, under which law the State wished to proceed. In that instance, if I understand it, it was under the State securities law and the Commission stepped in and, believe me, it was not something it enjoyed doing, stepped in because of the apprehensions that I expressed earlier about the extension of the States' securities law into the day-to-day administrative and paper-processing aspects of those laws.

There was nothing that would have precluded, so far as I know, that State from having proceeded under any of its civil or criminal antifraud statutes to achieve the same result. It was only the vehicle used by the State which caused the Commission to intervene.

Senator RUDMAN. But if we can carefully craft a dual jurisdiction statute that specifically addresses the criminal aspects of the securities law within each State, then I assume, as you testified previously, that it is something you could support.

Mr. JOHNSON. Senator, our Commission hasn't focused in on the refined distinction that you are making at this point. I will be happy to supply the subcommittee with an official position on that.

Senator RUDMAN. I think that would be very important because I think that there is strong support right now for giving States more jurisdiction.

Obviously, we don't want to go beyond what is reasonable because then we will have another problem. Then we will have people making at cross-purposes. What we are concerned about, I think, is that the States are giving all of the weapons they need, including their own securities laws with the proper definitions and limitations, to go after these scam operators. That is what we are interested in.

Thank you, Mr. Chairman. I have no further questions for this witness.

Chairman ROTH. Thank you. Mr. Chairman, I think it would be probably helpful if we could have your ideas because it is my intend to introduce some legislation in the near future. It would be most helpful if there were concurrences as to how we should proceed. I will say, I do want to go further than what I understand you are proposing.

I do have some questions from Senator Helms, but because of the vote, we will be unable to ask them in these hearings. I will, unless there is objection, keep the record open, and we will submit those questions and you can answer them in writing.

Mr. JOHNSON. I will be pleased to, Mr. Chairman.

Chairman ROTH. I want to thank you, and your other individuals, for appearing before us. We look forward to working with you in this area. Thank you, Mr. Chairman.

Mr. JOHNSON. Thank you very much, Mr. Chairman.

Chairman ROTH. I would like to call forward Mr. Isaacson. Is he here? Mr. Isaacson, we will have to proceed one of two ways. We either have to postpone your testimony until I am able to return, which will be at least a half hour to 45 minutes, or you can submit it in writing, whichever you prefer.

Mr. ISAACSON. We would rather come back in a half hour, if that is not an imposition.

Chairman ROTH. The vice chairman says he will be able to come right back, so we will be able to proceed accordingly.

Mr. ISAACSON. Thank you.

[Members present at time of recess: Senators Roth and Rudman.]

[Brief recess.]

[Member present at convening of hearing: Senator Rudman.]

Senator RUDMAN [presiding]. The subcommittee will be in order.

Gentlemen, the tradition and practice before the Permanent Subcommittee is to administer the oath to all witnesses. So if you would please rise. Are you both going to testify?

Mr. DUNCAN. I may testify.

Senator RUDMAN. Do you swear the testimony you are about to give in the course of this hearing will be the truth, the whole truth, and nothing but the truth, so help you God?

Mr. ISAACSON. I do.

Mr. DUNCAN. I do.

Senator RUDMAN. Thank you very much. Mr. Isaacson, I believe you have a statement that you would like to either read or summarize.

Mr. ISAACSON. Yes, I would like to read it.

TESTIMONY OF ROBERT L. ISAACSON, DIRECTOR, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS; (ACCOMPANIED BY: CARL DUNCAN, COCOUNSEL, NATIONAL ASSOCIATION OF FUTURES TRADING ADVISERS)

Mr. ISAACSON. First, I would like to introduce Carl Duncan with Abrams & Fox in Chicago and the National Association of Futures Trading Advisors' cocounsel.

My name is Robert Isaacson. I am president of Futures Investment Consultants, Inc., a registered commodity pool operator and commodity trading adviser. I am appearing this morning in my capacity as a director of the National Association of Futures Trading Advisors. We welcome the opportunity to present this statement to the Senate Permanent Subcommittee on Investigations in connection with its probe of illegal commodity investment schemes.

Specifically, our comments relate to the subcommittee's investigation centered on off-exchange commodity transactions and commodity pool operators as well as the appropriate role that State securities administrators should play in policing any fraud occurring this area.

As the subcommittee may be aware, NAFTA's membership is comprised of more than 120 of the industry's leading commodity trading advisers and commodity pool operators with over $700 million of client assets under management. NAFTA is a nonprofit professional association which seeks responsible ways to represent the interests of CTA's and CPO's to the public, the commodity industry and Federal and State regulatory agencies. NAFTA feels that its members represent a fair cross section of the CTA's and the CPO's currently registered with the Commodity Futures Trading Commission. Consequently, NAFTA believe that it is uniquely qualified to comment on this segment of the futures industry and the investing public whose capital is managed by the CTA's and CPO's.

In its recent release announcing these hearings, Chairman Roth expressed significant concern that American consumers had lost hundreds of millions of dollars by investing in fraudulent transactions involving such commodities as gold, silver, oil, gas, and strategic metals. After observing that many investors were being conned into investing by boilerroom telephone sales operators and slick promotional materials, Chairman Roth concluded that no investor is safe from such shady operators.

NAFTA shares the chairman's concerns for any such commodity scams. We decry any situation in which members of the public are defrauded of their moneys. Moreover, NAFTA supports well designed disclosure standards and diligent enforcement of antifraud standards by State as well as Federal authorities. In fact, in its 1980 comprehensive comment letter relating to that agency's then-proposed CTA/CPO regulations, NAFTA urged the CFTC to work with the States to take a greater enforcement role in this area. NAFTA believes that the States' emforcement experience and efforts provide a valuable, supplementary role to the CFTC's antifraud enforcement efforts.

It should be emphasized, however, that most of the scams this subcommittee will be addressing are not commodity futures contracts, the primary instruments subject to the jurisdiction of the CFTC. Hence, any investment scheme which relates to gold, silver, oil, gas, strategic metals, for example, is not necessarily subject to CFTC regulation.

NAFTA does not dispute that various ripoffs which nominally have the color of commodities do occur. However, many, if not most, of the investment scams which will be described before the subcommittee could, to use CFTC Chairman Philip Johnson's phraseology, be characterized as "frauds masquerading as legitimate commodity investments." They should be so prosecuted.

Let me offer specific examples of what I mean. Each of the following off-exchange situations nominally involves a commodity but is not subject to CFTC jurisdiction: Coal tax shelters, rabbit or cattle breeding, jojoba bean farming, investment diamonds, numismatic coins, oil and gas exploration, silver or emerald mines.

Thus, it is an unfair criticism to argue that the CFTC hasn't been doing its job. Each of these enumerated investment schemes have had their share of frauds. Alternatively, they can be prosecuted as a fraud or, in appropriate circumstances if an investment contract is involved, as a securities violation.

Accordingly, we would urge the subcommittee in its examination to discriminate between legitimate commodities activities subject to the effective jurisdiction of the CFTC and off-exchange activities which are not subject to its regulatory jurisdiction. This would include such broad areas as cash commodities, so-called forward contracts, and a whole spectrum of investment situations that cannot be effectively regulated by the CFTC.

Senator RUDMAN. Mr. Isaacson, I do want to advise you, due to the kind of day the Senators are having today, we now have another rollcall vote. I would not like to hold you beyond this period of time. I can stay here for approximately another 12 minutes. If you would like to summarize your statement in any way, I would be happy to have the entire statement placed in the record as if read. If you would like to summarize the remaining 10 or so pages or if you would prefer not to do that, then you may go as far as you can go. I will be unable to get back here after this rollcall.

Mr. ISAACSON. I think what I would like to do is perhaps summarize it and then answer any questions.

Senator RUDMAN. I would appreciate it if you would do that, going through your statement.[1]

Mr. ISAACSON. Rather than going through it, let me summarize a little extemporaneously.

We represent a facet of the industry of commodity trade advisers and pool operators. We feel we do a legitimate job for the investing public. We represent 6,000 clients. All those clients are satisfied, otherwise they still wouldn't be investing with us.

We also feel what Chairman Johnson said about 50 different rule make it impracticable for advisers or pool operators to be able to serve the investing public. We need one central body whose rules we want to comply with. Otherwise, what we will feel is the investing public will be deprived of legitimate investment alternatives.

Senator RUDMAN. You stated in your prepared text, your statement, that your organization believes in a supplementary role for the States.

Mr. ISAACSON. Yes, sir.

Senator RUDMAN. I would like a better definition of what that means. Do you support current CFTC/State jurisdiction in criminal prosecution?

Mr. ISAACSON. We support the CFTC as it now is delineated and the way it is operating.

Senator RUDMAN. Do you support States having jurisdiction over their securities laws to prosecute fraud or any violations of those laws?

Mr. ISAACSON. Yes, sir.

Senator RUDMAN. I take it that you might give me a different answer if we got into the area of registration.

Mr. ISAACSON. The area we would oppose would be if the States get into an area of the North American Securities Commissioners trying to pass guidelines for commodity pools where they were stating what commodity advisers can charge, regulating commodity commissions, that type of thing. That is an area we feel the States should stay out of. That is an area the experts at the CFTC should regulate.

Senator RUDMAN. Of course, States do regulate a lot of other securities. They have blue-sky laws of their own. I am not saying this subcommittee necessarily advocates that degree of change, but it seems to some that States seem to be barred from this rather narrow area when they have had a good deal of success in regulating other securities which, in many cases, are as complex.

Mr. ISAACSON. I think that commodity pool operators and commodity trading advisers, when they issue a security and when they do a limited partnership, during that issuance process, they are subject to State blue-sky regulations. If a public offering is done, if Merrill Lynch or Bache does a public offering, they still have to comply with the blue-sky laws in which that is sold in. So we are not exempt from any particular registration.

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[1] See p. 242 for the prepared statement of Robert L. Isaacson.

Senator **Rudman**. What are you doing in terms of self-regulation with all of the problems we have had which may not essentially be part of your industry, but are certainly tangential to it and many of these firms hold themselves out with the titles of the same firms that belong to your organization.

Mr. **Isaacson**. I will answer the question in two ways. We strongly support the National Futures Association. We have been actively involved in the formation process and counseling them on areas of commodity pool operator and commodity trading adviser regulation, not self-regulation, but as an area of making the public aware, we are putting together information so that if an investor is considering investing in a commodity pool or with a commodity trading adviser we will publish a series of guidelines he can look at, sources of information, places of information he could go to to help him select an adviser pool operator.

Senator **Rudman**. You were here, I believe, during the testimony and exchange with Chairman Johnson.

Mr. **Isaacson**. Yes, sir.

Senator **Rudman**. You heard the dialog concerning their new pilot program, their new option program that relates to stock indexes, value line, whatever. How do you feel about a prequalification program, if you will, a suitability requirement that would be imposed on those who might participate in such a program?

Mr. **Isaacson**. I think the obligation is on the brokerage firm to qualify the people that are investing with them because those investors, if they feel they have been taken or they feel they have been robbed in any way, they can go to what we call in the industry——

Senator **Rudman**. Not, of course, unless there was something improper. Let's just take an example of a person that has a net worth of $50,000 or $60,000, a retired person. He gets kind of excited about things he reads in the daily press and the media and they come to one of these firms, goes into one of these new pilot options, puts in $15,000, $20,000 and just loses it. They would have no chance of recovery.

Mr. **Isaacson**. I think if they are exchange-regulated firms, they would. If their firms are on the exchange and, as I understand the pilot options program, it will be sold through exchange firms, then they will have a chance for recovery.

Senator **Rudman**. For what reason, that they were not qualified, that they were ignorant?

Mr. **Isaacson**. I am sorry, I misunderstood your question. I see what you mean.

Senator **Rudman**. If they lost the money honestly, then they have no recovery.

Mr. **Isaacson**. That is right.

Senator **Rudman**. That is exactly my point. I think some of the people we had in here yesterday, with all due respect, they were defrauded, they were the kind of people who might have made very sophisticated investments with very good firms, and they have no reason to make those investments. That is our point.

Mr. **Isaacson**. I agree, and the answer for those people, I think, is a commodity pool where they can pool their money with other people or option pool where they don't have exposure, they have limited liability.

Senator **Rudman**. I tend to disagree. I think the place for these people is probably in long-term certificates of deposit insured by the FDIC. At least that is what I would tell friends of mine.

Mr. **Weiland**. I need to enter several exhibits, Mr. Chairman, very quickly, before you close.

Senator **Rudman**. I want to thank you very much for appearing here. We will be working on legislation. Of course, you, I am sure, will continue to discuss this with our staff, and we are glad to have your input.

Mr. **Isaacson**. Thank you.

Mr. **Weiland**. Mr. Chairman, if I may, I would like to submit for the record two bulk exhibits, Nos. 9 and 10, which consist of responses to the subcommittee inquiries from States' securities administrators and attorneys general, No. 9.

No. 10 is responses from court-appointed receivers.

Senator **Rudman**. Without objection, they will be entered.

[The documents referred to were marked "Exhibits Nos. 9 and 10," respectively, for reference and are retained in the files of the subcommittee.]

Mr. **Weiland**. Also, a small group of exhibits for publication. They are prenumbered 11 through 19. [The documents referred to as "Exhibit Nos. 18 and 19" were submitted after the hearings were adjourned.]

Senator **Rudman**. Without objection, they will be entered.

[The documents referred to were marked "Exhibits Nos. 11 through 19," for reference and may be found in the Appendix beginning on p. 256.]

Mr. **Weiland**. I have two exhibits that do not need to be published. They are prelabeled 20 and 21. And, finally, I would like to submit for the record a statement of Robert K. Wilmouth, president of the Board of Trade, who was invited to testify and was unable to.[1]

Senator **Rudman**. Without objection, those exhibits and that statement will be entered.

[The documents referred to were marked "Exhibits Nos. 20 and 21," respectively, for reference and were entered into the files of the subcommittee.]

Mr. **Weiland**. I have nothing further, Mr. Chairman.

Senator **Rudman**. The Permanent Subcommittee on Investigations will now stand in recess at the call of the Chair.

[Whereupon, at 11:55 a.m., the subcommittee was adjourned.]

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[1] See p. 250 for the prepared statement of Robert K. Wilmouth.

APPENDIX

STAFF STATEMENT

HEARINGS ON COMMODITY-RELATED INVESTMENT FRAUD

Mr. Chairman and Members of the Subcommittee:

In June, 1981, the staff of the Permanent Subcommittee on Investigations (PSI) undertook an extensive study of various fraudulent commodity-related investment opportunities available to the public. The purpose of our study was twofold. First, we intended it as a means of determining the magnitude of the fraud problem, i.e., the number of commodity investors falling prey to high pressure sales techniques of so-called "boiler-room operations" and the amount of losses sustained by such investors. Secondly, we sought to uncover what factors, if any, existed within the federal regulatory scheme which might be contributing to the continuing victimization of investors across the country.

Since June, 1981 we have interviewed more than 135 people, including numerous individuals convicted in such schemes, their victims, and federal and state law enforcement personnel. We have also visited some 17 firms which deal in commodities and commodity related instruments in Boston, New York, New Jersey, California and Florida.

Several key issues surfaced during the course of the staff's study including: the consequences of the Commodity Exchange Act's preemption of state securities regulators, the inadequacy of the Commodity Futures Trading Commission's Reparations operation, the impact of "no-fault" CFTC registration, and the apparent necessity of clearly establishing a private right of action in federal courts for those who have been defrauded.

Based on our investigation, it appears that the magnitude of the problem is enormous and that major problems do indeed exist within the federal framework charged with the responsibility for regulating the commodities industry. Our review of commodity scams perpetrated since 1975 indicates that customer losses have been at least $1 billion (See Appendix). We also found that loopholes in current legislation and ineffective administrative programs have prevented the states from taking action against commodity offenders, deprived investors of adequate consumer remedies and produced an extraordinary recidivism rate among commodity schemers.

Scope of Study

Before turning to a detailed discussion of our investigative work, we would first like to qualify certain aspects of our study in order to provide a frame of reference for our findings.

From the outset, we distinguished activities occurring on the floor of an exchange from activities engaged in by non-member registrants or those who were involved in marketing a commodity not traded on an exchange (off-exchange trading). Our investigative resources were concentrated on fraud which has not or is not occurring on the exchange floors. We did, however, solicit information and suggestions from the legitimate commodity industry, including large exchanges.

At this point, it is worth noting that in 1981, 98,522,371 futures contracts were traded on the registered exchanges, almost three times the volume traded in 1976.* Since the average margin deposit required to purchase a contract is at least $2,000, approximately $200 billion was invested through the legitimate commodity market last year alone.

During the same time period, an inestimable number of futures, forward delivery, leverage and option contracts were sold off-exchange.

The Commodity Exchange Act and the CFTC

Substantially revised in 1974 and again in 1978, the Commodity Exchange Act authorizes the Commodity Futures Trading Commission, a five-member panel, to regulate certain trading activities in the commodities industry. Section 2(a) (1) of the Act defines a commodity to include certain enumerated agricultural products such as oats, barley and peanuts as well as all other goods, articles and services, rights and interests for which contracts for future delivery are traded. The Act, by definition, specifically excludes, however, certain financial instruments from CFTC jurisdiction although technically they would fall under the definition of a commodity.

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* Source: Futures Industry Association

The Commission is authorized to regulate the trading of commodity contracts for future delivery, commodity leverage contracts (a special type of commodity transaction) and commodity options. Such authority extends to jurisdiction over the trading of such contracts on boards of trade specifically designated as contract markets under the Act, i.e., the national commodity exchanges, and trading occurring off the exchanges. In addition, the Commission, through its Registration Unit, is authorized to register various commodity professions, namely futures commission merchants (FCMs), commodity pool operators (CPOs), commodity trading advisors (CTAs) and persons associated with FCMS (APs). The Commission also has the power to revoke, suspend or otherwise terminate such registration under specified circumstances.

Through its Enforcement Division, the Commission may commence either administrative or civil actions against fraudulent operators seeking to enjoin their wrongful conduct. Such action is taken where the Commission has reason to believe such persons are, among other things, misrepresenting investment opportunities, failing to segregate customer funds, or operating as a commodity broker without proper registration.

Where the federal court process is invoked, the Commission often asks for ancillary relief such as the appointment of a receiver who then is charged with the duty of marshalling company assets, if any, and redistributing them to defrauded customers. Civil penalties also may be assessed against violators of the Act. Lastly, matters such as fraud or manipulation may be referred to the appropriate law enforcement authorities for criminal investigation and prosecution.

The Commission, through its Reparations Unit, also serves as an administrative forum for the resolution of claims against firms or persons who are or should be registered under the Act. In those cases where reparations awards are made, the statute attempts to provide a mechanism for payment—the imposition of sanctions for failure to pay an award and the authority to enforce an award in federal court.

Specific Areas of Investigation

We initiated our investigation by undertaking an extensive review of Commission files, particularly those maintained by the Division of Enforcement and the Reparations Unit. We also engaged in numerous discussions with CFTC personnel in the Reparations, Enforcement, Registration and Economics and

Education Units in Washington, as well as Enforcement personnel in Chicago, New York and San Francisco regional offices.

Our initial review of the files maintained by the Reparations Unit led us to undertake a more in-depth analysis of the Unit's effectiveness as a forum for consumer redress. Later in this report, the details of this analysis will be described; in addition, the GAO has made certain findings in this area in anticipation of the CFTC's reauthorization hearings before the Agriculture Committees this year.

Our review of CFTC enforcement operations consisted of numerous interviews and file reviews. The Staff created its own case study files. These files contained data in the various actions brought by the Commission involving off-exchange transactions over a five-year period. A primary objective was to develop evidence of the number of customers and the amounts of money invested in off-exchange, largely non-regulated transactions. We found the CFTC to have no clear idea of the amounts of customer losses. Hence, Chairman Roth solicited statistics from receivers who had been appointed in a substantial number of these cases and in cases involving defunct commodity pools. Several of these receivers also were interviewed by Subcommittee staff.

In addition to quantifying the losses due to these schemes, the Staff sought to determine how they are being set up and why certain individuals seem to be able to move from one scam to another with impunity. Several individuals recently convicted of commodity fraud were interviewed in jail and some suspected of involvement in illegal activity were visited at their current "commodity investment firms."

Several case studies are provided in an Appendix which illustrate the magnitude of the commodity fraud problem and how schemes are perpetrated. An analysis of the responses received from the receivers is also included.

As stated earlier, a key issue which surfaced was the inability of the states to effectively take action against scam operators in light of the preemption provisions of the Act. Although Section 6d (enacted in 1978) permits states to institute federal actions against fraudulent operators who violate provisions of the federal Act, the legislative history of the Act makes it apparent that the states are preempted from taking any action based on their own state commodity or security laws.* In light of this statutory mandate, Senator Roth solicited from approximately 30 state attorneys general and securities commissioners information pertaining to their experience in policing commodity fraud and any recommendations, legislative or otherwise, which they might have to remedy the situation. Subcommittee staff have also interviewed several of these state authorities.

While the CFTC does not have the authority to bring criminal actions, it will refer matters to the Department of Justice (DOJ). We specifically requested statistics from DOJ, the Federal Bureau of Investigation, and the Postal Inspection Service on the number of cases and investigations involved in commodity fraud. However, because DOJ does not maintain its records according to the type of investment fraud but rather by the statutory violation involved, i.e., mail fraud, wire fraud, etc., to date they have not provided us with statistics. The Postal Inspection Service did provide us with statistics which are summarized below.

85 Commodity Fraud investigations undertaken by Postal Inspectors (FY 79 - FY 81)

39 of these investigations conducted jointly with other agencies:

Agency	Number
Federal Bureau of Investigation	18
Commodity Futures Trading Commission	9
United States Attorney-Task Force	2
Internal Revenue Service	1
State/local agencies	9
TOTAL	39

34 cases referred to United States Attorney for consideration of prosecution;

9 cases prosecuted resulting in 26 indictments and 24 convictions;

3 cases resulting in 3 indictments - prosecution pending;

6 cases closed - no prosecution;

16 cases - action by U.S. Attorneys pending.

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* The states are not precluded from bringing suits based on general state criminal or anti-fraud statutes.

Subcommittee staff interviewed federal prosecutors in Miami, Boston, Washington, D.C., and Los Angeles to ascertain some of the problems they have encountered in prosecuting commodity fraud cases. From these interviews it is clear that prosecuting commodity fraud has rarely been a priority item in any U.S. Attorney's office.

Subcommittee staff also conducted several unannounced walk-in visits at commodity firms. We spoke with representatives of the following firms:

1. Atwood & James Petroleum Corp. (Miami, Florida)
2. Boston Strategic Investment Group (Boston Massachusetts)
3. Bullion Reserves of North America (Los Angeles, California)
4. Chartered Systems of New York (North Miami, Florida)
5. Don Charles Commodities, Inc. (Ft. Lauderdale, Florida)
6. Eastern Capital Corp. (Boston, Massachusetts)
7. ERG Resources (Ft. Lee, New Jersey)
8. First Financial Corporation of America (North Miami, Florida)
9. Hitech Development Corporation (NY, NY)
10. International Gold Bullion Exchange (Ft. Lauderdale, Florida)
11. Montgomery Advisory Corporation (Jersey City, NJ)
12. Multi National Holding Corporation (N.Y., N.Y.)
13. New England Rare Coin Gallery (Boston, Massachusetts)
14. Pan American Oil and Gas Leases (Ft. Lauderdale, Florida)
15. Roan & Rutledge Strategic Metals (North Miami, Florida)
16. Trans-America Commodities Corp. (Boston, Massachusetts)
17. Universal Precious Metals (Ft. Lauderdale, Florida)

Senator Roth also solicited information and statistics from the four firms dealing in what is known as "leverage" contracts: Monex, Premex, International Precious Metals Corporation, and First National Monetary Corporation. Lastly, the Chairman solicited official position statements from the National Association of Attorneys General, the Counsel of Better Business Bureaus, and the North American Association of Securities Administrators.

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ENFORCEMENT

The Enforcement Division of the CFTC investigates and brings suits for violation of the Commodity Exchange Act (CEA). The Division is made up of two units: (1) Market Integrity and (2) Consumer Protection, each with about 50 staff positions. The Market Integrity Section has the responsibility of enforcement in and around those contract markets designated by the Commission. Market Integrity includes a Manipulation and Trade Practices Unit with branches in Chicago, New York and Washington and a Rule Enforcement Unit in Washington.

The Customer Protection Section concentrates on halting the sale of unlawful commodity contracts not traded on the CFTC approved exchanges. These include illegal commodity options, unauthorized leverage contracts and fraudulent operations. Staffed with 23 attorneys, 9 investigators and 11 secretaries, this Section has field offices in New York, Chicago and San Francisco. There is no office in Florida, where the majority of commodity related scams have arisen in recent years. Boston, the site of several gigantic schemes, also has no office. The San Francisco office is maintained solely for the benefit of the Enforcement Division. Meanwhile, West Coast frauds are centered in Southern California, near Los Angeles and Newport Beach.

Such logistics severely hamper the efficiency of the Enforcement Division. There do not appear to be sufficient personnel or offices for the Enforcement Division to exercise the exclusive jurisdiction of commodity regulation under the Commodity Exchange Act. The dilemma faced by the Enforcement Division can be illustrated by a look at the number of personnel available on both sides. A single commodity boiler room has been known to have 50 salesmen, several times the number of investigators employed in the Enforcement Division nationwide.

Despite these odds the Enforcement Division has met with success in many areas. In the last fiscal year alone the amount of civil penalties imposed has increased (up 345%), the numbers of persons permanently enjoined has risen (up 105%), more cease and desist orders have been issued (up 157%), and more customer money has been recovered by court appointed equity receivers (up 461%).

At the same time, however, the number of public administrative proceedings initiated has dropped and the number of investigations opened have decreased from 777 in FY 1980 to 88 in FY 1981.* Understandably, the Division seems to have decided to commit its limited resources to those larger cases where success is more likely to be achieved. Even assuming that the larger case is successful and the huge operation has been shut down, literally hundreds of smaller operations may be selling the same scheme nationwide.

But the Enforcement Division's effectiveness against large operations cannot always be assumed. For example, in the light of the recent rush of schemes involving coal, the Division has chosen to focus on the National Coal Exchange, a monolith involving 16 different "exchanges" and 95 corporations in several states. Intended to be the CFTC coal case, the proceedings against the National Coal Exchange have been tedious and some states have instituted their own anti-fraud actions.

State Preemption

Cooperation between the CFTC and the states is a critical area of concern. Under Section 2(a)(1) and various other provisions of the Commodity Exchange Act, the Commodity Futures Trading Commission is given exclusive jurisdiction over the regulation of commodities. Until 1975, the states were able to enforce their own statutes concerning commodity fraud, and were effective in fighting commodity fraud. The states are now only permitted to appear in federal court to enforce the Act or to proceed under their own general anti-fraud statutes. If the state officials wish to enforce the federal Commodity Exchange Act, they may have to receive special authorization from their state legislatures in order to appear in federal court.

In addition, the Commission's interpretation of Section 8(e) of the CEA precludes effective cooperation by providing that the CFTC may not share information with the states. Richard Latham, Securities Commissioner of Texas, is just one of the state officials frustrated by the CFTC. As he has said:

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*It should be noted that this decrease is in some part attributable to a reclassification of what constituted an investigation. This redefinition, however, took place in 1979.

> While CFTC officials may pay lip-service to the concept of Federal-state cooperation, they are in fact uncooperative and even obstructive when state securities investigations attempt to enforce the provisions they are charged to enforce. Currently, boiler room solicitors are using the preemptive cloak of protection provided in the CEA to maraud into Texas, by mail and by telephone. The state's enforcement efforts currently are further hampered by (the) CFTC's jealousy of its own jurisdiction. I respectfully submit that (the) CFTC's record does not justify its "dog in the manger" approach to law enforcement.*

The lack of resourses, coupled with the exclusive jurisdiction of the CFTC, has proven frustrating for persons attempting to work with the Commission. Receivers appointed in injunctive actions to marshal remaining assets have often been less than impressed with the CFTC cooperation. Howard Schneider, receiver for Probber International Equities** told Senator Roth that he often felt as though the CFTC were an adverse party. Lawrence Burnat, receiver for Rothschild Commodities,* and James Johnson, receiver for Chillcott Portfolios,** has stated that if the CFTC can not be adequately funded to perform its duties, then it should be abolished and its functions turned over to some other body.

Return of Options

The problem becomes more serious as the CFTC approves new and different futures contracts for trading. As the Commision approves more exotic types of contracts, the number and extent of commodity fraud operations is more likely to grow. Perhaps the best example is the return of the Commission to options. The rampant growth in the mid-1970s of operations which claimed to sell options but actually sold worthless contracts resulted in a ban on commodity options trading in the United States. Section 4c(c) of the Commodity Exchange Act, 7 U.S.C. §6c(c) (Supp III 1979) prohibits the offer and sale of any commodity options until the Commission provides Congress with proof that such transactions can be regulated successfully.

In 1981, the Commission adopted regulations authorizing the trading of options on futures contracts on the exchanges, subject to Congressional approval. So far, eight U.S. exchanges have applied to trade options on commodity futures contracts on gold, platinum, sugar, bank certificates of deposits and Treasury bills.

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* From letter to Chief Counsel from Richard Latham dated Oct. 7, 1981

** From letter to Senator Roth, dated December 8, 1981

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* From letter to Senator Roth, dated October 28, 1981

** From letter to Senator Roth, dated October 20, 1981

The Enforcement Division, which will be charged with the enforcement of options regulations, however, appears woefully understaffed and unable to cope with a flood of options fraud cases. Yet, many people interviewed by the Staff believed that an official approval of options trading will immediately stoke the fires in boiler rooms across the country. Pyramid schemes may proliferate. The staff received indications that New York boiler room operators are ready to move on options as soon as legitimate trading begins. As Carolyn Duncan cf the Alabama Division of Securities told PSI staff, "Given the regulatory efficiency of the CFTC in the past, options will be a bloodbath. It will be institutionalized ponzi." Several members of the Enforcement Division have expressed this same concern.

Leverage Contracts

As noted earlier, Section 19 of the Commodity Exchange Act provides special "grandfather clause" treatment for the four firms trading what are known as "leverage contracts." In order to ascertain the nature of these instruments and their relative importance in terms of public investment the Chairman posed a series of questions to the firms. The firms all responded by generally explaining that a leverage contract is an off-exchange agreement for purchase or sale for delivery at a later date. Hence, it is similar to a futures contract but in a leverage contract the leverage dealer acts as a principal to every transaction and sets the price of every transaction.

The CFTC has never promulgated a comprehensive set of regulations for these off-exchange instruments. By law, futures contracts must be traded on a contract market. In 1979, the CFTC charged Monex and First National Monetary Corporation with illegally selling futures contracts which are not traded through contract makets, but this litigation has not been aggressively pursued by the CFTC. Recently, a federal judge enjoined the CFTC administrative proceedings based on the contention that the CFTC was trying to accomplish through litigation what it had failed to do by administrative rulemaking. (FNCM v. CFTC & Monex v. CFTC, Civil Nos. 81-74307, 81-74572 (E.D. Mich. Dec. 29, 1981)).

Meanwhile, the lack of regulation continues despite the enormous value of the contracts sold by these firms. Our study showed the following figures for gross receipts* of these four firms:**

1978	1979	1980
$842 million	$2.636 billion	$1.894 billion

Moreover the firms' responses to the Chairman's inquiries indicated sometimes astronomical salaries and commissions paid to salesmen. One firm put the average figure paid in 1980 at more than $86,000, another at more than $79,000. Even in less volatile commodity years salaries were substantial Some of these firms put their number of salesman near 100.

The CFTC has consistently maintained that it has exclusive jurisdiction over leverage contracts and its position has been upheld in the courts. Although numerous reparations complaints have been filed against the firms they have never been accused of fraud by the CFTC.*** Meanwhile the CFTC has just voted for another two year study of leverage contracts the result of which will be to continue the leverage monopoly currently enjoyed by the four firms now in business as a result of the grandfather clause exemption.

REPARATIONS PROCESS IN THE CFTC

One potential remedy for the customer who has been victimized by a commodity fraud scheme is the "reparations" process authorized under Section 14 of the Commodity Exchange Act. This program provides that any person may institute an administrative "reparations" proceeding against persons registered under the Commodity Exchange Act for a violation of the Act or any of the Commission sponsored rules or regulations promulgated thereunder. The Commission has interpreted the language of Section 14 to apply to persons who should have been registered under the Act as well. This is an important holding since, at least prior to 1981, commodity fraud artists made little effort to be registered with the Commission.

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* Gross receipts = total value of contracts sold at date of sale.

** These figures are approximate since one firm reported on a fiscal year rather than calendar year basis.

*** The president of Monex consented to an injunction against fraud filed by the SEC in 1975.

A reparations action is instituted by filing a complaint with the CFTC's Complaints Section, which is currently under the administrative supervision of the Commission's Executive Director. The Complaints Section is designed to serve as a clearinghouse for customer complaints and supposedly investigates to determine whether customer complaints should be processed further.

Our review of the Complaints Section indicated a serious problem of understaffing. Perhaps because the section is being reorganized, PSI investigators encountered enormous problems in locating files. Many were incomplete, missing, or according to the CFTC, simply "unavailable." An initial review by Subcommittee staff found 1,200 cases unaccounted for. After various sets of files were located over a period of two weeks, the number of missing cases shrunk to a "mere" 100.

Getting Into Reparations

The first step for the defrauded customer is to have his complaint accepted by the CFTC. In past years the initial review of complaints was sometimes handled by clerical personnel who decided whether the complaint stated a cause of action. Thus, they decided the fate of the complaint. For example, during FY 1980 the Complaints Section received 1,401 claims, but only forwarded 721 to the Hearings Section for further action.

But there are other reasons for being turned away. For example, in 1981 Eugene Manley of Montana complained to the New York Attorney General about Mineral Resources, Inc., a Manhattan company from which he had recently bought $1,700 worth of tantillum, a "strategic" metal. New York sent him to the CFTC where he was told "the CFTC does not handle strategic metals" although he had been told by the Commission before purchasing that the firm was registered with the CFTC. Much to his amazement he was denied reparations. Meanwhile the CFTC has sued a large strategic metals firm in Florida.

Staying In Reparations (Sometimes Forever)

Once the Complaints Section determines that a valid cause of action has been stated the complaint is forwarded to the respondent for an answer. The case is simultaneously forwarded to the Hearings Section for assignment to an administrative law judge (ALJ). Thereafter, numerous rules and regulations of the Commission relating to reparations proceedings are triggered and the victimized customer enters the never, never land of reparations litigation.*

Although it was designed by Congress to be an easy, quick, and efficient method of resolving customer claims, the reparations process has developed into a veritable nightmare for the defrauded customer. He faces any of a series of obstacles in his effort to actually recover money after the filing of his claim. In the words of the director of CFTC's Complaints Section, "there are currently inordinate delays in the operation of the total reparations system of the Commission." (Commodities Law Letter, Volume No. 3, (May, 1981)). Indeed, as indicated below, our study has confirmed the director's belief.

Once a customer's case is into the Hearings Section, any number of problems may arise. For example, in January, 1979, William and Maria Henderson of Charleston, S.C., brought a $10,000 claim against Comvest, Inc. Twenty-two months later the case finally reached the Hearings Section (due in part to a 4-month delay by the Hendersons in sending the filing fee). Suddenly, in May, 1981, the administrative law judge sent a prehearing order requiring both sides to make a statement. When the Hendersons failed to respond promptly he issued an order announcing their case would be dismissed July 16, 1981 if they were not heard from. The Henderson returned from a trip on July 14, 1981, and quickly sent in a letter of explanation.

This time the process worked, however. On July 20, three days before the CFTC received the Henderson's letter, the ALJ dismissed their case. There was never an explanation as to why they were not granted a default judgment years before and numerous other complaints against Comvest remained pending.

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*Claims amounting to less than $5,000 are handled by a Hearing Officer of limited jurisdiction.

Delays

Delays in the reparation process can occur at any of several stops along the way: (1) There can be a delay in the forwarding of the complaint from the Complaints Section to the Hearings Section; (2) After the complaints are received by the chief administrative law judge, it may take weeks or even months for the judge to assign the case to one of his brother administrative law judges, apparently on the assumption that the other administrative law judges already have a backlog of cases and further assignment would serve no useful purpose. (3) Once the respondent is served with the complaint, he has, theoretically, 45 days to answer and any failure to do so is deemed to be an admission of guilt. That is, after 45 days, the respondent is entitled to default judgment. Our study has shown that default judgments are seldom granted after 45 days and, indeed, the respondent may wait for months or even years before being granted a default judgment. Consider, for example, the following cases:

(A) On November 14, 1977, Gerald Anderson of Glendale, Arizona, filed a complaint for $7,150 against First New York Investors Corporation. His complaint found its way to the Hearings Section on November 7, 1978. It is still awaiting a hearing date some 51 months after filing.

(B) Mr. and Mrs. Daniel Chu of La Jolla, California, filed a claim for more than $40,000 against Premex, Inc., a "leverage" firm on July 7, 1980. On November 24, 1980, complainants received a post card notice that their case had been received by the Hearings Section from the Complaints Section. On July 6, 1981, counsel for complainants asked for a default judgment via letter to the Hearings Section. On August 21, 1981, counsel for Premex wrote the Hearings clerk to confirm a telephone conversation he had with the ALJ's secretary and to reiterate that an answer and counterclaim "would be forthcoming by August 28, 1981." This is where the matter rested as of January, 1982, 19 months after filing.

(C) On September 22, 1980, the Hearings Section notified James Farris of Hattiesburg, Mississippi, that it had received his file from the Complaints Section. On February 6, 1981, counsel for Mr. Farris wrote the Hearings Section this simple letter:

Re: John M. Farris vs. Pacific Precious Metals (80-R1135)

Dear Sir:

May I please have a status report on the above styled cause.

The letter was received in the Office of the Hearing Clerk on February 17, 1981 and never answered. No action has ever been taken in this case.

(4) Once the case actually comes under the consideration of an ALJ the process may work fairly rapidly--at least until the ALJ is called upon to render his "initial decision."

Delays between the close of evidence and initial decisions are sometimes lengthy. Productivity levels vary greatly among the various ALJ's.*
(5) After an initial decision, the next step in the process involves a review by the Commission of the decision of the ALJ. Either party may petition the Commission for a review and experience has shown that such petitions are commonplace. Since the losing party can invest whatever funds he may be required to pay to the petitioner at money market rates, and the Commission may charge only 12% interest during any interim review period, it is obviously in the best interest of the respondent to seek review. Our study has shown that the Commission may require months to decide the case at this level.

Assuming all has gone well for the defrauded customer up to this point in the reparations process and that he has indeed secured a judgment against the respondent and such judgment has been upheld by the Commission, he then faces what may be the last and frequently most insurmountable obstacle along the way, that is, enforcing his judgment. Theoretically the losing party must pay a reparations judgment or he will be sanctioned--lose his registration. But this mechanism has had little effect against respondents who are not reputable. It is too easy to register under a different name. By statute, the defrauded customer can take his judgment to a U. S. District Court and secure an "execution" from the clerk. A U. S. Marshal can then levy on whatever property may be available. This means that the Marshal will make a "return" indicating which property he has levied on, the result of which is a lien in favor of the defrauded customer. He receives no physical custody of such property at that time however. What frequently happens is, assuming the customer has been fortunate to find the respondent in possession of some tangible property, the respondent then moves the property to another location and the customer must find it again. A far more efficient method is to have the Marshal levy on a bank account, but such accounts are equally, if not more difficult, to locate.

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*At one point, Subcommittee staff discovered a case in which an order should have been issued over two years ago. When questioned why the ALJ had not yet entered an order, a CFTC Hearings staff member replied, "he's out of town a lot."

Bankruptcies/Receiverships

If the subject of a complaint is known by reparations staff to be in bankruptcy or receivership the complaint will be either rejected by the Complaints Section or put on "hold" in the Hearings Section. Since commodity thieves are continually going broke or being sued, it is not uncommon for the reparations cases of defrauded customers to stack up like cord wood at the CFTC. Where the company has been looted or the funds have been diverted outside the company, reparations proceedings are almost totally ineffective remedies, according to Barrington Parker, the receiver of Fairchild, Arabatzis and Smith.* Since there is no money to recover there is no need to move the cases. These are some examples:

Case Number	Date Filed	Amount of Claim	Date Stayed
R77-217	4/77	$ 2,500	3/78
R47-304	5/77	4,302	3/78
R77-335	5/77	4,209	3/78
R77-360	5/77	4,780	3/78
R79-276	12/78	14,262	9/80

Leverage Complaints

Without doubt, the greatest number of complaints by category of entity charged have been lodged against so-called "leverage firms." These four firms enjoy a special relationship by statute (Section 19 of the Commodity Exchange Act) based upon the unusual instrument they market. Without addressing the history of the regulation (or lack thereof) of the leverage industry, it is clear that there is virtually no state or federal regulation of the four firms today.**

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* From letter to Senator Roth dated November 17, 1981.

**See The CFTC and the Return of the Bucketeers: A Lesson in Regulatory Failure, M. Van Smith, 57 N.D. L. Rev. 1 (1981).

Statistics compiled by the CFTC to December, 1981 indicate the following number of complaints lodged in the Hearings Section from the beginning of reparations until December, 1981 with their overall "ranking":

Rank		Complaints
(1)	First Commodity Corp. of Boston (non-Member FCM)	130
(2)	Rosenthal and Company (Member FCM)	97
(6)	Monex (Leverage firm)	64
(10)	Premex (Leverage firm)	44
(11)	International Precious Metals Corp. (Leverage firm)	42
(12)	First National Monetary Corp. (Leverage firm)	38

It also appears that leverage contracts tend to involve a larger amount of money than other such contracts. Information from the Reparations Unit shows that from April, 1980 to November, 1981, the average leverage complaint was for an amount over three times larger than the average complaint involving futures, pools and off-exchange instruments.

Overall Reparations Statistics, Including Recoveries

The Staff's analysis of reparations statistics required the work of two investigators for approximately three weeks since many statistics of interest are unavailable at the CFTC. The staff counted each file and continually sought documentation of existing CFTC statistics from Commission personnel. Ultimately our inquiry showed as follows:

REPARATIONS CASES

ARISING

FY 1978 - FY 1981

COMPLAINTS SECTION		CASES		AMOUNT CLAIMED
Received from complainants		4,594		$125,528,470.92
Still Open		441		29,277,531.56
Balance		4,153		$ 96,250,939.36
Disposition:				
Dismissed	1,034		$16,249,467.78	
Settled	246	1,280	1,633,790.18	17,883,257.96
		2,873		$ 78,367,681.40
HEARINGS SECTION				
Received from Complaints Sec.		2,873		$ 78,367,681.40
Open Cases:				
Assigned to ALJ	1,093		27,544,518.65	
Default	153		5,407,273.00	
Awaiting filing fees	320		6,075,235.62	
Fees paid, not assigned	193	1,759	7,401,538.44	46,428,565.71
Balance		1,114		$ 31,939,115.69
Closed Cases:				
Dismissed	212		2,242,083.14	
Settled	344		4,371,542.15	
Defaults	242		5,913,144.00	
Other Decisions	213	1,011	2,596,543.71	15,123,313.00
Cases Unaccounted for		103*		
Value of Cases with no disposition				$ 16,815,802.69

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*The staff was advised that it is not uncommon to have 100 claims unaccounted for. They are usually floating between the Complaints and the Hearings Section.

REPARATIONS CASES CLOSED BY THE HEARINGS SECTION

FY 1978 - FY 1981

DISPOSITION	NUMBER OF CASES	VALUE OF CLAIMS
Settled	344	$ 4,371,542.15
Decisions	213	2,596,543.71
Dismissed	212	2,242,083.14
Defaults	242	5,913,144.00
	1,011	$15,123,313.00

CASE RESULTING IN CUSTOMER AWARDS

	Number	Est. Value of Settlement* or Actual Amount of Judgment
Settled cases		
(1) in Complaints Sec.	246	$ 1,143,653.13
(2) in Hearings Sec.	344	1,967,193.97
Default cases	242	5,913,144.00
Litigated cases	213	2,596,543.71
Total	1,045	$11,620,534.81

ACTUAL RECOVERIES BY CUSTOMERS AFTER SETTLEMENT OR JUDGMENT

Settled cases	(590) est.	$3,110.847.10
Litigated cases	(47)	226,813.85
Default cases	(24)**	295,657.00
	Total	$3,633,317.95

Thus, we estimate only $3.6 million was actually recovered in Reparations during this period. This represents 2.9% of total claims.

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*According to CFTC average settlement at complaint stage = 70% of claims and at hearings stage = 45% of claim.

**The staff estimates that perhaps 5% of default judgments are actually collected. The CFTC has no figures and does not offer estimates of actual default recoveries. The staff's random sample failed to disclose anyone who had actually recovered on a default.

REGISTRATION

Under Section 4 of the Commodity Exchange Act, it is unlawful for futures commission merchants, floor brokers, commodity trading advisors, commodity pool operators or their associated persons to engage in futures trading without registering with the Commodity Futures Trading Commission. Section 6 and 8 of the same Act, provide reasons for which registration shall be granted or denied, including minimum capitalization requirements, felony convictions and misrepresentations made on registation applications.

There are currently over 50,000 persons registered with the CFTC in some capacity. Each of these persons has had to register initially and then re-register each year, or every 2 years for associated persons. A person registers with the CFTC by filing a registration form, which lists, among other things, past business and educational background, any civil or criminal sanctions which have been imposed, and the nature of the business which the applicant proposes to run. This form is then reviewed to determine completeness and accuracy. If this review discovers no problems, then the applicant may be registered upon payment of a registration fee. Over the last 3 fiscal years the Reparations Unit has granted an average of 13,000 initial and 16,500 renewal registrations each year. The registration fees collected in 1981 amounted to over one million dollars.

The Registration Unit, which is responsible for all registrations, investigations and collection of fees, consists of 17 persons - 11 in Chicago and 6 in Washington. The Chicago staff consists primarily of GS-5 clerks who initially review the applications for registration. These clerks will check to see that all questions are answered and to spot applications which may require investigation. Hence, these persons constitute the primary defense against unfit persons becoming registered.

During its investigation of the commodities industry, the Subcommittee has found repeated instances of the inadequacy of the CFTC registration procedure. The review of a form by clerks does not adequately screen out applicants who are unfit to be registered. According to Michael Unger, Director of the Massachusetts Security Division: "A re-occurring problem has been the discovery that individuals become licensed by the CFTC although the applications are incomplete or misleading. It is apparent that there is inadequate review of license applications by the CFTC."* While the 17 persons of the Registration Unit are doing an admirable job of processing thousands of applications, they are unable to provide the review needed to ensure that unfit persons do not become registered. Richard Latham, Securities Commissioner of Texas, told the Subcommittee in his letter, "I regret to say that the licensing and disclosure requirements enforced by the CFTC are hopelessly inadequate to inform the public what some unscrupulous operators are doing."

Even when forewarned, the Commission may be unable to screen out unsuitable persons. For example, on February 27, 1980 the Chief of the Massachusetts Securities Registration Section wrote the Commission advising that the Commission scrutinize the application of Inn-Vest, Inc., in light of a relation with Global Oil Corporation and Dennis Cioffi. On that same day, however, Inn-Vest was registered as a CTA, by one Dennis Cioffi. On March 3, 1980 the CFTC referred Global Oil and Cioffi to the FBI for investigation. Despite these warnings, Inn-Vest was re-registered as a CTA, under Cioffi's name, on July 1, 1980. Soon thereafter, Cioffi was indicted for fraud and conspiracy to defraud, later resulting in a hung jury.

The Registration Unit does have a computer to check these applications, but the system was designed in 1973 and consequently is quite antiquated. The computer performs a basic filing function but has no capability to detect even the simplest form of deception that a knowledgeable applicant could utilize. There is no centralized system to correlate information that may exist in other CFTC Divisions for the same applicant. These limitations enhance the burden of applicant screening placed on the GS-5 clerks in Chicago.

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* From letter to Chairman Roth dated January 5, 1982.

Any problem applications which the Chicago office spots are sent to the Washington office which is composed of three investigators, two support persons and an assistant director. At any given time, the three investigators must handle approximately 350 cases. In addition, about 50 investigations a year are contracted out to other federal agencies. CFTC investigations take about 6 months to resolve and only about 2% of all investigations result in the issuance of an order of denial of the applicant's registration.

Many other applicants will voluntarily withdraw upon receipt of notice that the Commission has found particular reasons to deny their registration. Since such withdrawal does not appear on any record, it is simple for an unscrupulous applicant to amend the answer which the Commission deemed offensive and resubmit the application, without prejudice.

Merely File A Form

Section 4p of the Commodity Exchange Act (1974) provides that the Commission may prescribe "written proficiency examinations" to ensure the fitness of registered persons. These examinations would make sure that persons registered by the CFTC would sufficiently understand the industry to provide competent services to their customers. Eight years later, however, no written proficiency examinations have been implemented, nor are any serious steps being taken for such implementation. Even if registration could ensure a registered person's legitimacy, which it can not, there is no guarantee that the registered person even understands the commodity business. Similarly, regulations regarding fingerprinting have been authorized but no action has been taken towards implementation. As the system currently exists, a simple alias can thwart any protection otherwise provided by the Registration Unit. For example, we found one individual who worked for 7 different boiler rooms under the names: Bob Leeds, Tony Ross, Bob Roma, and William Roth. Fingerprinting is a solid means of determining that the person is who he says he is, and the CFTC has the power to implement rules to require fingerprinting of registered persons. The CFTC, however, has not chosen to promulgate such rules.

PSI investigators found one individual, Bernard Bauman who, while being the subject of complaints to the CFTC involving five different firms, all of which had been enjoined for trading violations, is registered as an associated person and is acting as a supervisor of an active commodity phone sales operation, Chartered Systems of Miami, Florida. When asked by PSI investigators if he knew of his employee's history, the manager, Sheldon Yablon, replied that, "If he can get registered, then he's alright by me." The CFTC has finally decided to require that nonclerical employees of CTAs and CPOs register as associated persons. Long overdue, this action will fill one of the many gaps in the registration procedure. Enjoined fraud operators and even convicted felons have long used this registration void to remain in the business. Jack Robinson, a Boston CTA who ran Trans-America Commodities until recently, told us that he employed individuals who had been sued by the CFTC. Robinson saw no problems since the CFTC itself did not require that these persons be registered; he would not provide these names without a subpoena. Robinson began his career at the First Commodity Corporation of Boston, a company which recently settled after being sued by the CFTC in a major case.

There is also the case of Thomas Pepe who was the prime mover of Republic Advisory Corporation, a recently enjoined New Jersey commodity dealer. Pepe ran this organization after being enjoined in the Bartex crude oil scheme in Manhattan. Then, after Republic Advisory folded, Pepe created a new venture called "Public Advisory Corporation." Public, however, also soon closed.

There are also no means by which to detect if the registered individual is merely fronting for an individual whose sordid past might preclude registration. A notorious commodity schemer, unable to become registered, will recruit a figurehead who will receive a percentage of the profits for the use of his name. The schemer will organize, train and run the boiler room. He has no official title in the business structure, but large checks will go to him as a "consultant". This practice is rampant in the commodity industry today, according to the convicted commodity scheme operators with whom PSI staff members met.

Cloak of Respectability

CFTC registration, meant to promote integrity, is often twisted to provide respectability to firms which deserve none. It is not difficult to find a person who will lend his, as yet unsoiled, name and background to the firm in order to obtain registration. Once this is done, customers suspicions may easily be overcome by stressing that the firm is registered with the federal commodity regulator, the CFTC. The prospective client is often told to call the CFTC and verify the firm's claim of registration.

When the customer calls, he is indeed told that the company is registered, a fact which is public information. The customer, assuming that registration requires exhaustive scrutiny, is often convinced to purchase an "investment", that in several months may prove worthless. Karl F. Lauby, Vice President - Operations of the Better Business Bureau of Metropolitan New York, told the Subcommittee that unscrupulous firms "use the credability of the United States Government as an aid in perpetrating their schemes. In many cases, the CFTC registration was a license to steal."* What the customer will not be told is that the company in question may be the subject of numerous complaints or even soon to be the subject of civil or criminal actions. Securities Commissioner Latham has stated in his letter, "When (we) called to find out if someone is licensed with the CFTC, the CFTC would confirm whether the name given was licensed, but would provide no more information on the subject."

When a customer receives a call from an out-of-state firm, verification with the CFTC is often a means by which a customer can check up on the firm. In the more remote states, it may be the only means. Thus, the ineffectiveness of the registration process particularly effects the residents of those states. As Willis Kirkpatrick, Director of the Alaska Department of Commerce has said "The fact that a firm or party was licensed offered no assurances of protection to the Alaska investors."**

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* Letter to Senator Roth dated January 3, 1982.
** Letter to Senator Roth dated October 29, 1981.

-APPENDIX-

OVERVIEW OF TYPICAL ILLEGAL COMMODITY OPERATIONS

There is very little that is unique in any given commodities scheme. In fact, they are startlingly similar. Though the product sold may vary from currency to gold, oil, titanium, etc., the basic operation remains pretty much the same.

Most of these operations are what are known as "boiler-rooms". A group of telephone salesmen make unsolicited calls to unsuspecting individuals and employ hard sell tactics in order to coerce the customer into a quick sale. These rooms operate behind impressive sounding names and attempt to browbeat the customer with seemingly important connections and references.

In actuality, the "firms" usually consist of a rented room crammed with desks and phones. Salesmen are hired for their brazen persistence alone; no actual knowledge of commodities is necessary. The less a salesman knows about a product the less restrictions are on him while speaking to customers. These salesmen make blatant misrepresentations and twist facts as they see fit, destroying any tenuous legality which the operations might have had originally. There is little training and less supervision of these salesmen. The salesmen are taught to think of prospective customers as "mooches" who are holding money in their pockets which should be in the salesman's pocket.

The key to selling a product that does not exist to a perfect stranger is to build the excitement of this prospective sale to a fevered pitch. A very large sale is considered a great accomplishment, enhancing the status of the salesman in the eyes of his peers. There is also a great deal of money involved. Salesmen's commissions can run as high as 50% of the sale. In this industry, a single sale of $10,000 is common and sales as high as $100,000 are not unheard of. Thus, one successful phone call by a salesman can yield thousands of dollars. The use of stimulants, including amphetamines and cocaine is common. Salesmen are packed, shoulder to shoulder, in order to feed off the excitement of each other. Often two or more salemen will be on the phone in order to wear down any resistance the customer may offer. Prepared sales pitches are read verbatim, and responses to customer objections are indexed to provide a prompt rebuttal. The best salesmen will be employed as "loaders" and will recall customers who have already purchased in order to try to sell even more of these worthless contracts.

Customer's names are usually compiled and sold and resold throughout the industry. A customer's name and phone number can bring as much as $30 a piece. In fact, the compiling and selling of names is an industry in itself. Salesmen jealously guard the names they have obtained and will recontact the customer from time to time. Interestingly, the customers who have been cheated once are the most ripe to be taken again, in that they are anxious to recoup their past losses.

High commissions, large phone costs, flagrant misrepresentations, and the ever-present greed of the principals ensure that the investment which the customer believes he is buying will never materialize. The date the contract becomes due, usually 6 months to one year later, frequently corresponds very closely to the time the company is dissolved, the assets hidden and the sales staff dismissed to find another boiler room in which to work. Customers will be very lucky to get any of their investment returned. The principals will start a new boiler room somewhere else and new avenues of fraud are explored.

Brief sketches of the more typical schemes follow.

ARCHARAY ENTERPRISES

Raymond Day, an experienced phone salesman, established Archaray Enterprises in August of 1978. Day had been registered with the CFTC as an associated person but that registration had expired. Archaray itself was never registered with the CFTC. With $900 and 3 phones in a rented room, Day began selling "deferred delivery" contracts on gold, silver and oil. One year later, Archaray employed over 50 salesmen, had 270 customers in 41 states and had taken in $2.5 million. Archaray salesmen were paid up to a 50% commission and an Archaray selling agent, Euro American Currency, was paid over $200,000 in commissions.

In September of 1979 the FBI raided Archaray Enterprises. Raymond Day was indicted in December 1979 and on May 5, 1980 plead quilty to 12 counts of mail and wire fraud and one count of selling commodity options in violation of the Commodity Exchange Act. He received a sentence of four years (79 Crim. 691 (N.D. Ill. 1979)). It was clear that, from early on, Archaray had little or no coverage of the contracts they sold. In fact, it has been estimated that if Archaray had covered all of the contracts which were sold that those contracts would have been worth over $19 million.

A receiver was appointed and FBI figures show that $462,000 was returned to clients. For the most part, however, clients lost almost all of their investment and made none of the profits that could have been made had Archaray done what was promised.

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ASHTON & ST. JOHN INCORPORATED

Ashton & St. John's was a commodity pool operation which registered with the CFTC in January 1979. It was the creation of a 38 year old, Jamaican-born, electrician named Wilbert Wilson. Although Wilson had no formal education in investments, he apparently worked for the investment firms of Neuberger Securities and Fairchild, Arabatzis & Smith, both of which were shut down by the CFTC for unlawful actions.

Wilson registered as an associated person with the CFTC and created a telephone sales operation which eventually employed over 25 salesmen. These salesmen were paid as high as a 50% commission for their sales, a mark up which tends to make legitimate sales impossible. With no apparent restrictions these salesmen promised prospective pool participants a guaranteed 60% annual return on their investments.

In reality, only 20% of all funds received were even invested in futures contracts. The rest went to Wilson and the salesmen. Dividends were paid to customers out of new money coming in, despite the fact that the few contracts that were bought actually diminished in value. The entire operation was a ponzi scheme, where new money was used to cover old obligations.

In February of 1980, CFTC auditors discovered that Ashton and St. John's and Wilson had failed to segregate customer funds as required under the Commodity Exchange Act provisions and violated disclosure, reporting and bookkeeping provisions of the Act. Blatant misrepresentations were made as to the background, performance and profits of Ashton and St. John's.

The CFTC instituted injunctive action in 1980 on the same day federal agents served a search warrant. In 1981 a permanent injunction was entered and a receiver appointed. It has been determined that Ashton and St. John's took in approximately $3,750,000 from 800 customers in 48 states and Puerto Rico. Approximately $975,000 was recovered; investors lost about 75% of their original investment.

On October 31, 1980 an 82 count indictment was filed against Wilbert Wilson in the Southern District of New York. Wilson is currently a fugitive and his whereabouts are unknown. Two others have been indicted.

Prior to Wilson's departure the federal judge handling the civil case awarded him $35,000 out of customer funds to cover the "legal and accounting fees" he was about to incur.

COMERCIAL PETROLERA INTERNACIONAL/BARTEX PETROLEUM

In early 1979, Richard Waggoner purchased a defunct corporation in Panama, named Persian Gulf Corporation. This company was renamed Comercial Petrolera Internacional (CPI) and under Waggoners direction began to offer contracts to purchase crude oil for future delivery. CPI held itself out to be worth over 15 million dollars, and offered 6 month or one year contracts for grade "27-34 API" oil at spot price. CPI guarenteed price rises, repurchasing, limited risk and payments of up to 300% in 6 months.

Edwin Bederson then incorporated the International Petroleum Exchange to be the exclusive North American representative for the sale of CPI's oil contracts. After a bribe was paid, Bederson obtained a Dun & Bradstreet report of CPI's solvency. Kenneth Levin and James Morse then established the Bartex Petroleum corporation to act as a wholesaler for the sale of these contract and to set up and train retailers. Twenty-seven other companies were established in eight states to sell these contracts to the public, the hub being in New York City. Large scale high pressure phone sales by these retailers subsequently resulted in the sale of at least $3.5 million worth of these contracts to over 600 customers nationwide.

Unfortunately, the entire CPI network was a mere facade. CPI not only did not have the oil, or the capacity to store or obtain the oil, but it is also a fact that grade "27-34 API" oil did not exist. CPI was a simple shell. Assets were inflated and reports forged. The spot price was merely what Waggoner wanted it to be. The guarantees were worthless and salesmen told customers any lies necessary to make a sale.

In December of 1979, however, the CPI network began to crumble. It became obvious that contracts coming due would not be filled. Principals hurriedly secreted tens of thousands of dollars away in foreign bank accounts. Waggoner, the creator of the entire charade, cashed a $60,000 CPI check and became a fugitive.

In 1980, on the heels of an action brought by New York State, the CFTC sued to permanently enjoin all of the CPI companies from selling the oil contracts. Subsequent criminal actions resulted in the convictions of Bederson, Levin, Morse and Waggoner. CPI and its subsidiaries were put into receivership. At this date, however, less than $400,000 of the estimated $3.5 million received by CPI has been recovered.

FAIRCHILD, ARABATZIS & SMITH

In April, 1977, Fairchild, Arabatzis and Smith, Inc. (FAS) was incorporated and obtained a license from the CFTC to operate as a future's commission merchant. Steven M. Arabatzis, the driving force behind the corporation, set up offices on Wall Street and hired salesmen to sell London commodity options. In unsolicited calls to persons whose names had been bought from Dun & Bradstreet, salesmen used canned sales presentations to mislead and deceive the customer. Representations of ensured profits and other guarantees were routinely made. Where there was enough time to recontact the customer before he realized he was defrauded, the salesmen would attempt to get the customer to purchase even more, a practice known as "loading".

In one year, FAS took in $4,393,345 from over a thousand customers; only $221,851 was returned. In 1977, Arabatzis had a crew of over 60 salespersons, working day and night with sales of up to $200,000 per week. Options were marked up 100% and salesmen received 50% commissions. In early 1978, Arabatzis diversified into commodity pools and within months was able to raise and squander $647,000 in customer funds. Those few funds that were actually invested were constantly churned to obtain trading fees.

In mid-1978 even this thievery was not enough. Arabatzis began direct embezzlement of customer funds, juggling accounts to pay off debts and ordering the entry of fictional credits. At the same time Arabatzis created the Astor and Montcalm Corporation, which claimed to sell deferred delivery gold contracts. In fact, Astor & Montcalm charged exorbitant service charges and rarely bought gold to cover the contract. Of the 143 Astor & Montcalm investors who paid in $942,142, only eight investors received back a total of $1,887. Late in 1978, Arabatzis opened National Trade Exchange, Inc., which did little or no business.

In October of 1978, the CFTC closed FAS and Astor & Montcalm by injunctive action and the appointment of a receiver. The receiver had determined that approximately 1300 people in 45 states and Canada lost about $6 million. The receiver was able to marshal only slightly over $50,000 worth of assets from both FAS and Astor & Montcalm.

Arabatzis and another principal of the company, Robert F. Feuillebois, were indicted. See U.S. v. Steven M. Arabatzes, 79 CR. 86 (S.D.N.Y. 1979); U.S. v. Robert Feuillebois, 79 CR. 260 (S.D.N.Y. 1979). Arabatzis pled guilty to 4 counts of mail fraud and was sentenced to two consecutive five-year prison terms. Feuillebois was given probation.

JEFFERSON NATIONAL INVESTMENT CORPORATION

In June of 1977, Bobby J. Howell and Thomas Crowley incorporated the Lincoln Federal Investment Corporation (LFIC). J. Daniel Sledd was hired and became LFIC's highest paid salesman. Offering "London options", LFIC sold at mark-ups of 50% to 600% and did not cover all of the options that it sold to the public. In May of 1978, the CFTC brought an action against LFIC for violation of CFTC requirements regarding record keeping and segregation of funds. Pursuant to consent decrees by the principals, LFIC was put into receivership. After an examination of LFIC records, the receiver concluded that a fraud had been perpetrated and that LFIC had taken in $850,000.

In June 1979, Howell, Sledd and Crowley set up the First United Investment Corporation (FUIC), at the same location where LFIC had operated. FUIC offered deferred delivery contracts on gold and silver which was allegedly stored in the Cayman Islands. In fact, FUIC never even attempted to cover all of their contracts and used the Cayman Islands to transfer customer money out of the country, where it could not be traced. In October of 1978, FUIC ceased doing business, after it had fraudulently obtained at least $400,000 from investors.

That same month, Howell and Sledd incorporated the Jefferson National Investment Company (JNIC), located across the hall from the FBI branch office in Clearwater, Florida. JNIC purported to sell precious metals which were allegedly stored in the vaults of the European International Depository in Geneva, Switzerland. JNIC sales operations consisted entirely of solicitiations over the telephone. In fact, JNIC never bothered to print up brochures, advertisements or even order forms.

JNIC sold its program until November of 1979 when the FBI seized its records and caused the company to shut down. It became clear that there was no Geneva company; there were no vaults; there never was any metal. There was nothing to indicate that JNIC had ever made any effort to cover any of the contracts sold to its investors. Over 150 investors from 26 states had invested $1,317,500 with JNIC.

Howell and Sledd quickly appropriated hundreds of thousands of dollars to themselves and "insider" customers. In 1980, John Daniel Sledd and Bobby J. Howell were indicted by a special grand jury in the Northern District of Illinois, and were charged with 15 felony counts of mail and wire fraud. Sledd and Howell were convicted and sentenced to federal prison terms of 4 and 5 years, respectively.

REPUBLIC ADVISORY CORPORATION

In May of 1980, the Republic Advisory Corporation (Republic) began selling long term futures contracts. These contracts, argued by some to be inherently fraudulent, require a large initial investment which allegedly provides for a year long position in the futures market at no risk to the customer. Republic, registered with the CFTC as a commodity trading advisor, promised to trade the customer's account as many times as required during the year for one flat fee.

What the customer could not have known was that Republic was registered by Maria Pepe, the wife of the undisclosed real principal of Republic, Thomas Pepe. Thomas Pepe's past associations with several commodity schemes deterred him from trying to register himself. Once Republic was registered, however, Thomas Pepe brazenly held himself out as Republic's head, often personally visiting Republic's futures commission merchant to conduct business. It was Thomas Pepe who set up the operation which took the customer's accounts, made unauthorized trades and, then charged the customer a commission fee for these accounts. The customer's equity, supposedly frozen for one year, was soon whittled away from fees for unauthorized trading. Twenty salesmen were employed to enlist more and more customers into the scheme.

After one year of operation, the Republic was faced with a CFTC injunctive action to which most of these principals consented. During that year, however, more than 500 customers had invested over $5,750,000, of which the court appointed receiver has recovered less than $100,000. Reparations cases at the CFTC against Republic have proven fruitless since the principals of Republic are unavailable for service of process and recoverable assets are otherwise unavailable.

Republic had barely shut its doors, however, when Pepe started up Public Advisory Corporation and two salesmen from Republic, John Moran and Joseph Fienga, created Multi State Advisory Corporation. Both started selling the same program for which Republic was enjoined. Though Public Advisory floundered, Multi State used 8 salesmen to sell $500,000 worth of contracts in 5 months. In this case, however, a CFTC injunctive action was able to shut down Multi State and recover over $300,000.

PROBBER INTERNATIONAL EQUITIES CORPORATION

Probber International Equities Corporation (PIEC) operated for six months from mid-1978. Created by Lloyd Probber, PIEC was set up to deal in commodity futures contracts and tax shelters. The staff's study indicated Probber has been involved directly or indirectly with numerous boiler room operations. During the operation of PIEC, Lloyd Probber demonstrated a total disregard in his responsibilities with respect to customer funds, often using them for personal purposes.

In less than 24 weeks of existence, PIEC was able to obtain over one million dollars from 135 customers in 34 states. An injunctive action instituted by the CFTC in U. S. District Court resulted in a permanent injunction against PIEC and the appointment of an equity receiver. The equity receiver has determined that investors will receive no more than 16% of their original investment.

The CFTC has referred the matter to the Justice Department which filed an information against Lloyd Probber on November 25, 1980. Probber has pled guilty to four felony counts and is awaiting sentencing.

FIRST GUARANTY METALS CORP.

First Guaranty Metals Corporation (FGMC), a Division of Trending Cycles for Commodities, Inc., was a Florida firm which purported to sell "leverage" contracts in gold and silver. In December of 1981, two of the principals of FGMC and its general counsel were indicted, charged with wire and mail fraud and commodity fraud. The indictment alleges that FGMC, while claiming to buy metals and futures contracts to cover client purchases, in fact used the clients' money to pay salesmen commissions and expenses and rarely used the customers' money for purposes of covering investments. Without this hedging protection, FGMC would be nothing more than a "ponzi" scheme, only using new money to cover old debts.

Currently in bankruptcy, FGMC had approximately 1500 customers and took in $15,000,000. These customers came from 48 states and Puerto Rico. Charges against FGMC included misrepresentations about inventory, prices, delivery and the actual value of the investment purchased. Although some money was returned to placate suspicious customers, about one half of all money received by FGMC allegedly went to salaries and commissions.

FGMC's general counsel pleaded guilty to one felony count of commodity leverage fraud as part of a plea agreement on January 6, 1982.

INTERNATIONAL GOLD EXCHANGE, INC.

International Gold Exchange (IGE) was an operation opened in 1978 by Robert Little and Adam Philips in Miami, Florida. It was a telephone sales operation which supposedly sold deferred delivery of physical gold. In fact, all that was sold were options which were not backed by any physical gold.

IGE salesmen used prewritten sales pitches which guaranteed large profits, denied the existence of any risk and generally misrepresented the manner in which transactions were executed. Some reports indicate that single sales to customers totaled as much as $100,000. A few customers were sent small amounts of physical gold, but the large majority of IGE customers' money went to IGE's principals and salesmen.

In 1979, IGE, its principals, salesmen and subsidiaries consented to a preliminary injunction brought by the CFTC. This action enjoined IGE from trading and misrepresentation of business information. A receiver was also appointed to marshal all assets and redistribute IGE funds to its customers. The receiver found that 487 customers had sent over $5 million to IGE. As of August 4, 1980, only $766,520.06 could be mustered by the receiver. Less than 17 cents on the dollar were returned to IGE clients.

U.S. METALS DEPOSITORY CORP.

U.S. Metals Depository Corp (USMDC), also known as Metals Depository Corp., sold what they were calling "deferred delivery" contracts. The U.S. District Court for the Southern District of New York, however, was of the opinion that these contracts were illegal commodity options (79 Civ. 1201, (S.D.N.Y. 1979)).

USMDC was created and operated by James Morse, a principal in six different commodity schemes which resulted in customer losses in the millions of dollars. USMDC was a classic "boiler room" operation. USMDC employed over 150 salespersons working 24 hours a day, crowded shoulder to shoulder, making unsolicited phone calls to potential investors. These salesmen used high-pressure sales techniques to induce hasty investments, ignoring the buyers' needs and misrepresenting material facts about the investment. Using prepared scripts, salesmen with no investment training would guarantee that extraordinary profits were a certainty. Phone calls were followed by the mailing of misleading literature, which were in turn followed by a high pressure call which attempted to force an instant decision to invest. In less than one year, USMDC took in approximately $8 million from almost 2,000 customers nationwide. The court appointed receiver of USMDC has, however, been able to muster less than $100,000 from the remaining accounts and assets.

USMDC was eventually closed down by a permanent injunction obtained by the CFTC. It is doubtful, however, that any of USMDC's customers will receive even one cent for each dollar which they invested. Morse has since been convicted of 3 counts of mail and wire fraud in the Bartex Petroleum case and, while serving his sentence in a federal correctional institution, was indicted again in 1982.

ONE OR MORE OF THE INDIVIDUALS PERMANENTLY ENJOINED IN CFTC v. COMMERCIAL PETROLERA INTERNACIONAL, BARTEX, et. al. (Civ. No. 80-689 (S.D.N.Y. 1980)), HAVE WORKED FOR, OR BEEN A PRINCIPAL IN, THE FOLLOWING COMPANIES:

PRE-COMMERCIAL PETROLERA INTERNATIONAL

American Currency Exchange
* Archaray Industries
* Astor & Montcalm
* Chartered Systems, Inc.
* Crown Colony Commodity Options
* Currency Specialists, Inc.
Euro-American Commodities, Ltd.
* Fairchild, Arabatzis & Smith
[illegible]eral Mid-West [illegible]pository
* First Commodity Corporation of Boston
International Commodity Options
International Currency Exchange
* International Gold Exchange
* J.M. King, Inc.
* Lloyd, Carr & Co.
* Metals Depository Corporation a/k/a/ U.S. Corporation Metals Depository
* Morgan, Harris and Scott
* New Era Precious Metals
* Pyne Commodities, Inc.
* Rothchild Commodities

CPI/BARTEX

POST-COMMERCIAL PETROLERA INTERNATIONAL

* American Coal Exchange
* Consolidated Advisory Corporation
* Eastern Capital Corp.
* Energy Resources Group Resources, Inc.
Federal Precious Metals
I.G.B. Trading Corporation
Kingston Commodity Corporation
* Mineral Resources Corporation
* Multi-National Corporation
* National City Trading
* National Coal Exchange
* Precious Metals Associates
* Public Advisory Associates
* Republic Advisory Corporation
Strategic Resources Corporation
* Tech Industries

* These companies have either been prosecuted criminally or have been permanently enjoined at some point for trading violations.

A few of the many examples of individuals working for several commodity sales operations within the last five years.

DOMENIC IACIOFANO	SOURCE OF INFORMATION
American Petroleum & Oil Exchange	CFTC v. CPI (S.D.N.Y. 1980)
International Metals Exchange	CFTC Complaint
Kingston Commodity Corporation	CFTC Complaint
PMA Commodities Corporation	CFTC Complaint
Precious Metals Associates	CFTC Complaint
LEWIS MONK	
Commodities Incorporated	Florida Corporate Records
Euro-Gold Transfer Corporation	Florida Corporate Records
International Gold & Commodities	Florida Corporate Records
International Gold Transfer Corporation	Florida Corporate Records
Reserve Precious Metals	Florida Corporate Records
STEVEN SAWYER	
Continental Precious Metals	CFTC Complaint
First Commodities, Inc.	CFTC Complaint
First Regal Commodities Inc.	CFTC Complaint
National Marketing Services	Florida Corporate Records
Prestige Metals Depository, Inc.	CFTC Complaint
Stanford Management	CFTC Complaint
RAYMOND DAY a/k/a Tom Brown	
Archaray Enterprises	Admission to PSI Staff Members 12/8/81
Bristol Options	Admission to PSI Staff Members 12/8/81
Chartered Systems, Inc.	Admission to PSI Staff Members 12/8/81
Fairchild, Arabatzis, & Smith	Admission to PSI Staff Members 12/8/81
First Investors Corporation	Admission to PSI Staff Members 12/8/81
Herbert Young Commodities	Admission to PSI Staff Members 12/8/81
BERNARD BAUMAN	
Chartered Systems	CFTC Complaint
Crown Colony Options,	CFTC Complaint
First National Bullion Corporation	CFTC Complaint
First National Currency	CFTC Complaint
International Gold Exchange	CFTC Complaint
International Monetary Corporation	Wisconsin Complaint
Neuberger Securities Corporation	CFTC Complaint
JAMES MORSE	
Alpha Currency	N.Y. State criminal prosecution
Bartex Petroleum Corporation	CFTC v. CPI (S.D.N.Y. 1980)
Commodity Options, Ltd.	CFTC Injuctive Action (78-19), 1978

	Source of Information
J.M. King & Associates	*CFTC v. J.M. King* (S.D.N.Y. 1978)
Pan American Trading	CFTC Injunctive Action (78-79), 1978)
U.S. Metals Depository Corporation	*CFTC v. Metals Depository Corp.* (S.D.N.Y. 1978)
SAMUEL MIZRAHI	
Bolard Precious Metals,	CFTC Complaints
First Dover Commodity Options	CFTC Complaints
James T. McKerr & Company	CFTC Complaints
National City Trading Corporation	(81 Crim. 363, S.D.N.Y. 1981)
Republic Advisory Corporation	CFTC Complaints
Republic Resources of America	CFTC Complaints
Sutton Wells Securities Corporation	CFTC Complaints
RONALD NAGORNIAK	
American Currency Exchange	Florida Corporate Records
American Petroleum Exchange	Florida Corporate Records
International Monetary Exchange	Florida Corporate Records
International Monetary Marketing	Florida Corporate Records
New Era Oil Development	Florida Corporate Records
RT&J Trading	CFTC Complaint
United Commodity Options, Ltd. Inc.	Florida Corporate Records
U.S. Petroleum Exchange	Florida Corporate Records
EDWIN BEDERSON	
Chartered Systems	CFTC Complaints
Bartex Petroleum Corporation	*CFTC v. CPI* (S.D.N.Y. 1980)
Currency Specialists, Inc.	Admission to PSI Staff Members 10/10/81
Euro-American Commodities, Ltd.	Admission to PSI Staff Members 10/10/81
International Clearing Exchange, Inc.	Admission to PSI Staff Members 10/10/81
International Currency Exchange	Admission to PSI Staff Members 10/10/81
International Petroleum Exchange	Admission to PSI Staff Members 10/10/81
Regent Commodity Services	Admission to PSI Staff Members 10/10/81
Strategic Industries, Inc.	Admission to PSI Staff Members 10/10/81
KENNETH LEVIN	
Bartex Petroleum Corporation	Admission to PSI Staff Members 12/3&16/81
British American Commodity Options	Admission to PSI Staff Members 12/3&16/81
Fairchild, Arabatzis & Smith	Admission to PSI Staff Members 12/3&16/81
Federal Eastern Depository	Admission to PSI Staff Members 12/3&16/81
Federal Metals Depository	Admission to PSI Staff Members 12/3&16/81
J.K.K. Consulting	Admission to PSI Staff Members 12/3&16/81
J.M. King & Associates	Admission to PSI Staff Members 12/3&16/81
Meridian Equities	Admission to PSI Staff Members 12/3&16/81
Strategic Resources Corporation	Admission to PSI Staff Members 12/3&16/81

WILLIAM ROTH a.k.a. Bob Leeds, Tony Ross, and Bob Roma

Chartered Systems,	CFTC Complaint
Cohn Commodities	CFTC Injunctive Action (78-55), 1978
Barclay Commodities, Inc.	*CFTC v. Barclay* (S.D. Fla. 1978)
International Royal Investors, Ltd.	*CFTC v. International Investors* (S.D.N.Y. 1979)
Oil and Gas Corporation	CFTC Complaints
Rockwell International	CFTC Complaints

ROBERT SHOHER

Atlantic Coast Silver Exchange	Admission to PSI Staff Members 1/12/82
American Currency Exchange	Admission to PSI Staff Members 1/12/82
American Petroleum Exchange, Inc.	Admission to PSI Staff Members 1/12/82
Chartered Systems	Admission to PSI Staff Members 1/12/82
Crown Colony Commodity Options	Admission to PSI Staff Members 1/12/82
Dash Investments	Admission to PSI Staff Members 1/12/82
EFCO Bank	Testimony in *U.S. v. Alter* (S.D.N.Y. 1980)
First Regal Commodities	Admission to PSI Staff Members 1/12/82
International Metals Exchange	CFTC Complaint
International Monetary Marketing, Inc.	Admission to PSI Staff Members 1/12/82
London Commodity Options	Florida Complaint
New Era Oil Development	Admission to PSI Staff Members 1/12/82
New Era Precious Metals	Admission to PSI Staff Members 1/12/82
Probber International Equities	Florida Complaint
RT&J Trading Corp	Admission to PSI Staff Members 1/12/82
Sabine Oil Exploration	Admission to PSI Staff Members 1/12/82
Williston Trading Corporation	Admission to PSI Staff Members 1/12/82
U.S. Petroleum Exchange	Testimony in *U.S. v. Alter* (S.D.N.Y., 1980)

JACK SAVAGE

American International Trading Company, *CFTC v. American International Trading Company* (C.D. Cal. 1976) Pyne Commodities Corporation (*CFTC v. Pyne Commodities* (S.D.N.Y. 1980)

The Subcommittee has also obtained information which is, at this time, unverifiable, but which the Subcommittee believes to be reliable, which places Jack Savage in:

Bartex Petroleum Corporation
Chicago Discount Commodity Brokers
Commodity Services International (Toronto, London, Naussau)
Incomco GMBH (Frankfort, Germany)
International Commodity Corporation
J.K.K. Inc.
J.M. King & Associates
North American Investment Company
North American Trading Company
Southern Cross Commodities (Adleaide, Australia)
U.S. Metals Depository Corporation

COMMODITY FRAUD
COMPUTATION OF INVESTMENTS AND LOSSES
1976 - 1981

Firm	Number of Customers	Total Investments	Total Losses	Percent Of Investment Lost	Average Investment	Average Loss
American Overseas Training Corporation	35	$ 140,000	$ 126,000	90%	$ 4,000	$ 3,600
Archaray Enterprises	269	2,000,000	1,996,900	100%	7,435	7,423
Ashton & St. John	800	3,750,000	2,275,000	61%	4,688	2,844
Bengal Trading	450	2,500,000	1,750,000	70%	5,556	3,889
British American Commodity	2,800	15,000,000	3,000,000	20%	5,357	1,071
Capital City Currencies	92	237,000	102,265	63%	2,576	1,112
Carr & Lemieux	3,900	27,000,000	20,850,000	77%	6,923	5,346
Chicago Discount Commodity	510	10,500,000	4,500,000	43%	20,588	8,824
Chilcott Portfolio Mgmt.	1,000	130,000,000	60,000,000	46%	130,000	60,000
CPI	600	3,500,000	3,450,000	99%	5,833	5,750
Currency Specialists, Inc.	1,244	3,753,500	3,700,000	99%	3,017	2,974
Euro-Swiss	2,000	37,000,000	35,700,000	96%	18,500	17,850
Fairchild, Arabatzis and Smith	1,300	5,500,000	5,203,777	95%	4,231	4,003
Federal Gold & Silver	325	2,360,000	2,242,000	95%	7,262	6,898
First Guaranty Metals	1,500	15,000,000	6,420,000	43%	10,000	4,280
First United Investment	40	230,000	230,000	100%	5,750	5,750
International Gold Exch.	487	5,689,469	4,426,656	78%	11,683	9,100
Jefferson National	156	1,317,500	953,281	72%	8,446	6,111
Morgan, Harris & Scott	294	1,286,000	1,100,000	86%	4,374	3,741
Probber International	135	1,100,000	944,000	86%	8,148	6,993
Pyne Commodities	287	1,700,000	510,000	30%	5,923	1,777
R & M Precious Metals	25	50,000	46,500	93%	2,000	1,860
Republic Advisory	573	5,730,000	4,870,500	85%	10,000	8,500
Sterling Capital	55	142,932	91,421	64%	2,599	1,662
Stuart Cohn	245	5,000,000	5,000,000	100%	20,408	20,408
Sweeney & Associates	112	781,000	773,971	99%	6,973	6,910
U.K. Commodity Options	3,000	10,500,000	9,450,000	90%	3,500	3,150
U.S. Investment	580	6,200,000	5,650,000	91%	10,690	9,741
U.S. Metals Depository	2,000	8,000,000	8,000,000	100%	4,000	4,000
TOTALS	25,714	$309,984,874	$196,862,271			

Continued...

COMMODITY FRAUD
COMPUTATION OF INVESTMENT AND LOSSES
(Continued)

LESS:	Number of Customers	Total Investments	Total Losses
Chilcott Portfolio	1,000	$130,000,000	$60,000,000
R & M Precious Metals	25	50,000	46,500
TOTALS:	24,689	179,934,874	136,815,771

Average Number of Customers	882
Average Losses/Firm	$4,886,276
Average Investments/Firm	$6,426,246

High and low figures eliminated from average.
Source of data: Court appointed receivers for each firm.

COMMODITY FRAUD
ESTIMATED CUSTOMER INVESTMENTS AND LOSSES NATIONWIDE
1976 - 1981

	Number Of Customers	Total Investments	Total Losses
Estimated Data:			
Assumes that data received from receivers on 28 firms are representative of 111 other firms which have CFTC cases during period of 1976 - 1981.			
Extrapolating from the average receiver figures produces:			
(882 x 111)	97,902		
($6,426,246 x 111)		$713,313,306	
($4,886,276 x 111)			$542,376,858
Data From Receivers	25,714	309,984,874	196,862,271
TOTAL ESTIMATED DATA	123,616	$1,023,298,180	$739,239,129
If CFTC sues only 1 of every 2 fraudulent firms, data becomes:	247,232	$2,046,596,360	$1,478,478,258

PREPARED STATEMENT OF KENNETH LEVIN

My name is Kenneth Levin. I am currently completing a one year prison sentence which I am serving for my part in a commodity fraud scheme. I pled guilty to one count each of mail fraud, wire fraud and conspiracy as a result of charges brought against me in Boston.

I began my career on Wall Street as a runner. In 1969, I became an over-the-counter trader for Contemporary Securities. In 1971, I began my own auto auction business, and in 1975, I worked for liquidating firms.

Since February 1977, I have been involved with numerous commodity sales operations. I started with British American Commodities earning a 10% commission. I left in August 1977, and moved to J.M. King Associates, a managed account firm, where I felt I could earn more money. In 1978, I started my own commodities firm (Meridian Equities) with three other investors. I left the firm soon after to become a commodities salesman for Fairchild, Arabatzis and Smith in New York. At Fairchild, I earned a 20% commission with a 10% override on referrals. British American, J.M. King and Fairchid were all sued by the CFTC and two criminal actions arose out of Fairchild, but I was not involved. I understand that the day before the CFTC closed British American's successor, First Regal Commodities, the principals stole $397,000 of segregated customer funds yet were never prosecuted.

In June 1978, I formed Federal Metals Depository Corp. with two other men. In October 1978, I also formed Federal Midwest Depository Corp. with a third person. Both these firms closed in December 1978. In January 1979, I opened Federal East Depository Corp. which subsequently closed in June 1979.

In August 1979, I formed Bartex Petroleum with James Morse. Morse and I were eventually convicted for our participation in the Bartex operation. We first became interested in this crude oil futures deal through a third person who presented us with a brochure. We made significant revisions to the brochure upon the advice of our attorneys in order to give potential customers more safety in the operation. Based upon this revised brochure, a Dunn and Bradstreet statement, references from a prominent Panamanian bank, and statements made by and through the third party contact, we decided to form Bartex in order to market crude oil contracts.

We had researched the firm initially to be convinced that it was a legitimate operation. It was not until November 1979 that I learned the operation was a sham. By then real volume trading was beginning to get underway so we continued to operate until we were closed down by a New York state cease and desist order in late December 1979.

HOW BOILER ROOMS OPERATE

Commodity boiler rooms are quite common in this country. There are many reasons for their numbers, not the least of which include the ease with which they can be set up and operated. Likewise, as a general rule, enforcement is spotty and penalties are rarely harsh.

I believe I could start up a boiler room operation that would be a total fraud for around $1,000. The only real expenses are telephone lines, desks, file cabinets and rent. If I really worked at it, I could probably earn around $100,000 a week on a high-ticket ($4,000 - $10,000) item. With a tax sheltered program, a 15-man operation could probably gross up to $40,000,000 a year. My earnings during 1979 were approximately $120,000 even though I worked sporadically.

As an indication of how easy it is to set up a boiler room, I know of one person who set up an operation while he was in prison. He had his man on the outside set it up. The person in prison kept the office profits and his man on the outside got a 2% override on the sales.

Boiler rooms generally consist of the owner, an office manager, and the salesmen. The rooms with which I am familiar were generally very small with the salesmen practically sitting on top of each other. This not only saves rent money, but helps build a high level of confidence in the salesmen. When a sale is closed under these circumstances, the excitement spreads throughout the room. The atmosphere of excitement in the boiler rooms makes them conducive to drug use also. Cocaine was very prevalent among salesmen who tend to be in the 25 - 35 age group. Pills and alcohol were also very common.

In my experience, most salesmen do not know whether or not the commodity they are selling is actually backed; nor do they ask. Few if any salesmen ever get prosecuted, and as a group they are not worried about law enforcement efforts much less the efforts of the Commodity Futures Trading Commission.

In many cases, salesmen help each other out. If one is close to closing a deal and runs into trouble fielding questions, another may get on the line to bring added pressure to bear on the customer. The keystone to the industry is, of course, extremely high-pressure sales.

Another device used by salesmen to make money is through the sales of their customer lists. Until 1979, most salesmen got names of prospective customers by buying them from Dunn and Bradstreet. Now many customer lists are sold by the salesmen themselves. A salesman's reputation can be greatly enhanced if a customer list he sells works out well.

People who reply to business reply cards sent out, and people who have lost money in previous commodity deals are excellent prospects for future sales. Other sources of names include those appearing in County records of tax shelters sold and lists copied by printers who are making up mailing lists for other clients. Selling names can prove quite profitable. I personally sold 3,000 names at $10 each just before I went to prison.

MANAGED ACOUNTS AND COMMODITY TRADING ADVISORS

Managed accounts, unlike boiler rooms, generally deal in legitimate commodities trading, but that does not prevent the business from being extremely lucrative. A client will pay an up-front fee of a fixed amount to a CTA. For illustration, I'll use $5,000. $2,000 of the $5,000 would go to the house. The other $3,000 would be for "maintenance cost". The enticement for the client is that he will receive 10 - 20 round-turns (buys and sells) at no additional charge. The commodity house makes its money from the $2,000 front end load. Then, in a week or two the salesman gets the client to sign a new managed account agreement which the salesman then churns for regular commissions. The customer generally ends up losing the entire $5,000 in a very short period of time. The house, of course, has no regard for trying to make the customer a profit.

CONTRACTS GENERALLY NOT BACKED

Deferred delivery contracts are designed to allow a customer to buy an item tomorrow at today's prices. They are not regulated by the CFTC. A down payment plus a management fee today guarantees delivery of an item three, six or nine months later at today's price. These contracts are supposed to be "backed" by escrow accounts or by the actual purchase and storage of the commodity bought (such as gold coins). It is my experience that such contracts are rarely backed except by the most reputable of houses. Therefore, only a few lucky people ever get even their original investment back. That only happens when the people scream loudly enough and the house can convert another contract in order to get the funds to repay the unhappy customer. Virtually none of the later customers get their money back, let alone make the profit they had been hoping for.

RECYCLED SALESMEN

Boiler room and churning salesmen tend to recycle themselves through the industry. Many of us know many others. Many of us have worked with many others at different houses. Certain commodity houses have acted as training academies for the inner corps of commodity salesmen. The three most prominent of these to my knowledge are First Commodity Corp. of Boston, Crown Colony, and Chartered Systems. If you put all the dozens of salesmen together who went through these houses at one time or another, you would have a very elite corps.

Similarly, boiler room operations tend to drift through the industry. They open one room and run it dry or until it is closed down, then they open another under a different name and do the same thing. This tends to continue until they are put in jail. As I mentioned earlier, some continue from jail.

REMEDIES

I do not think there are quick and easy remedies to the problem of commodities fraud. It is my experience that neither law enforcement or the CFTC frighten house owners or salesmen. Several states have tried to act quickly in shutting down houses. If that type of pressure could be kept up, it might begin to deter operators from opening new houses.

One area where enforcement is terribly soft is the prosecution of salesmen. A consistent supply of salesmen who are not afraid of being caught is the life's blood of the industry. If salesmen were consistently prosecuted along with the operators, it would make it very difficult to run a profitable house.

I think the most workable method of closing down the big operators is through putting long term undercover operatives in their houses. This would not only allow law enforcement to get the owner, but a good many of his salesmen also. It would also tend to spread paranoia throughout the fraudulent sectors of the industry. At present, most operators and salesmen I know think the field is wide open and totally untainted by fear of prosecution.

PREPARED STATEMENT OF RICHARD D. LATHAM

I submit this statement to you in my capacity as Securities Commissioner of the State Securities Board of Texas. In addition, I also serve as First Vice President of the North American Securities Administrators Association, a voluntary association of Securities Commissioners of the fifty states, the Canadian Provinces, the Yukon Territory, Puerto Rico and Mexico.

The Texas Securities Board is charged by state law with the regulation of sales of securities within Texas. As such, it is my duty to enforce the Texas Securities Act by detecting and preventing fraudulent investment schemes, including fraudulent commodity schemes if they have involved the sale of securities. Before the federal preemptive provisions of the Commodity Exchange Act took effect, my Agency did a considerable business in commodity fraud enforcement. The impact of those preemptive provisions on law enforcement and on the criminal justice system is the subject of my remarks today.

The experience of the State of Texas and the Texas Securities Board with commodity frauds began in the early 1970's, only a short time before the creation of the Commodity Futures Trading Commission. The State of Texas has never sought to regulate commodity futures trading, and before 1971 the sale of commodity contracts caused little concern to law enforcement officers. The operation of the national commodity exchanges have never been the subject of investigations or regulations of the Texas Securities Board, and exchange activities are not the object of concern of state securities administrators today.

In the early 70's, however, a new type of commodity trading was discovered to be a source of profit for a group of professional confidence men, who sold commodity-like investments to unsuspecting investors at huge costs to the public and to legitimate industry.

The first of these new schemes in commodity-like investments were commodities options. Federal law had made illegal the sale of commodity options on domestic commodities since 1936. The new options dealers of the 1970's dealt in options on the so-called "unregulated commodities" - those commodities not then sold on domestic boards of trade, such as sugar, coffee, and a variety of metals, particularly silver. The best known of the option dealers of the 1970's was Harold Goldstein's Goldstein-Samuelson, Inc.[1] That company sold over 175,000 phony commodity options contracts, valued at over $88 million, in less than two years.[2] Its premium income in only one month was about $15 million, and it had offices in every state, including Texas. Although investors were led to believe that this company and other option sellers were hedged by investments in real commodity markets, the naked option operations of the early 70's were nothing but bucket shops selling chances on the price of overseas commodities, secured only by the ability of the seller to collect money from new investors to pay off old investors.

The option games of the early 70's were simply variations of the classic Ponzi scheme, where the promoter promises fantastic profits to investors and uses the investment of one investor to pay off paper profits to earlier investors, thereby "robbing Peter to pay Paul". When state law enforcement officials realized the true nature of these schemes, state securities laws were used to put these Ponzi schemes out of business and prosecute the crooks. Between April, 1974, and January, 1975, the State of Texas brought 84 indictments against 28 individuals in Dallas, Houston and San Antonio as a result of securities investigations of option schemes by the Texas Securities Board. The indictments resulted in eleven felony convictions in Dallas and Houston from 1975 through 1977. Six injunctive actions were filed which resulted in six permanent injunctions and four receiverships being ordered. This activity occurred as a result of actions initiated prior to the effective date of the Commodity Exchange Act amendment which gave exclusive jurisdiction of CFTC and during a time when the Texas Securities Board devoted a substantial part of its investigative resources to the commodities area in an effort to stamp out the commodity option frauds in Texas.

The law enforcement activities against commodity fraud, the Texas Securities Board, the Attorney General of Texas and local criminal district attorneys were curtailed by passage of the Commodity Futures Trading Commission Act of 1974 and its federal preemption of state law enforcement activities. Unfortunately, federal preemption has not been accompanied by strong enforcement of federal laws prohibiting commodity related frauds, with the result that since 1975 a number of crooks have felt free to operate fraudulent businesses which have preyed on Texas investors.

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[1] Act of June 15, 1936, Ch. 545, §4c, 49 Stat. 1494.
[2] Smith, The Commodity Futures Trading Commission and the Return o[illegible] Bucketeers: A Lession in Regulatory Failure, 57 N.D.L. Rev. 7 (1981).

While enforcement actions filed in Texas against commodity related frauds has dropped to nearly zero, the fraudulent practices on commodity sales have continued. Our experience in Texas indicates that under the current regulatory scheme it is too easy for a crook to receive the "blessing" of a license from the CFTC, and that inadequate resources exist on the federal level to police the sales practices of licenses.

For example, during late 1980 my Agency received a complaint from a Houston resident about a commodity pool operator licensed by the CFTC. The victim had been convinced to purchase an interest in a commodity pool based on representations from the operator that it had a fantastic track record in commodity trading. This record turned out to be just that - fantasy. A short time after he invested, the investor received another communication from the pool operator. He was informed that as a result of an "informal settlement" of a disciplinary dispute with the CFTC, the operator was now disclosing his real track record. That track record, instead of showing profitable investments for over five consecutive years, showed that the pool operator had been in business only a short time and had lost money for most of that time. Despite the fact that the pool operator's salesmen had knowingly given potential investors false information about the operator's trading history, this operator had been allowed by the CFTC to remain licensed as a pool operator.

It should be noted that the Texas investor who complained to the Securities Board received a full refund from the promoter after being informed that distributing misleading information about trading results could be considered grounds for criminal prosecution in Texas.

With a few such exceptions, however, our state has been largely unsuccessful in protecting Texas investors from commodity frauds since CFTC preemption. One attempt was made to use the remedy currently contained in Section 6d of joining the CFTC in a federal injunctive action, but that attempt yielded unsatisfactory results. After an investigation by the Texas Securities Board, the Attorney General of Texas and CFTC filed a lawsuit in January, 1981, against International Bullion Clearing Corporation and Robert Greenberg, and a Temporary Restraining Order was obtained against the defendants. Since that time, Greenberg's lawyer has used a vast assortment of delaying tactics available in federal court to keep this lawsuit in limbo and keep his client from having to pay fines and restitutions under violations of the Texas Deceptive Trade Practices Act which were alleged in the same suit. A hearing on Temporary Injunction was finally held in February, 1982, but still no decision has been rendered in this case.

Further this is not the first commodity case which was filed against the defendant, Robert Greenberg. CFTC had previously sued United Petroleum Exchange Corporation and Greenberg to stop the sale of fraudulent futures contracts in crude oil. It was while that action was in its early stages that Greenberg set up International Bullion Clearing Corporation, which resulted in the suit in which the State of Texas joined.

This points up a basic flaw in the current scheme of Section 6d. You cannot effectively enjoin a professional criminal to stop his illegal acts. By precluding state securities administrators from bringing criminal securities fraud cases, a vital part of the criminal justice system is missing from the government's arsenal of weapons against fraud and theft. Anti-fraud provisions of securities statutes normally contain special sanctions, similar to the language in Section 10(b) of the 1934 Security Exchange Act, which are particularly designed to prohibit schemes such as those which have plagued the commodity business. This special language is commonly absent from "general" theft statutes under which the current CEA allows state prosecution. Two points should be noted regarding the failure of the current regulatory scheme.

1. The CFTC, with its emphasis on regulation of the national commodity markets, is not well suited to fight local anti-fraud enforcement problems.

The need for state law preemption has been supported in the past as a way to avoid duplicative regulation and create a single, homogenous system of regulation for national commodity markets. This is a laudable goal. It does make sense for a central agency to regulate the national boards of trade and review the new expansions the commodity markets are undergoing. As a state administrator I have no desire to interfere in that regulatory process. But the fraud problems are instead not occurring in the floors of national boards of trade. They are festering in telephone boiler rooms that constantly spring up, to later disappear, throughout the nation. A federal agency like CFTC is not suited to deal with these sales operations in Dallas and San Antonio when its nearest office for Consumer Protection is in Chicago.

As a matter of fact, CFTC has had its emphasis not on sales practices, but instead on market integrity and regulation. This is fine, but it leaves a gap in the regulatory framework. Not until January, 1982, did CFTC propose its rule requiring licensing of sales agents who actually sell commodity investments of the trading advisors and pool operators CFTC regulates. In the meantime, commodity salesmen with little or no knowledge of commodity markets have felt free to say anything they wanted in order to make a sale. For instance, in 1980 on three separate occasions, different commodity salesmen told the Director of my Enforcement Division that the pool the salesman sold was, "audited every month by CFTC," and the pool was "licensed by CFTC," so the investment was sure to be safe. The CFTC simply has not been able to deal with problems of sales practices, and prospects for improvement here seem dim, without tremendous expansion of the federal enforcement program.

2. The State governments, especially securities administrators, have the available resources and expertise to best fight the anti-fraud problems.

As I said earlier, the massive fraud problems I see are not occuring on the floors of national exchanges. We receive very few complaints about futures trading on recognized boards of trade, and I am satisfied to leave regulation of those markets to the federal government. In fact, current commodities fraud problems do not stem from traditional commodity trading at all. They come from sales of off-exchange, commodity-like investments--coal forwards, crude oil delivery schemes and the like. These exotic investments have in the past been the targets of successful state securities enforcement programs, and they should be returned to state jurisdiction for criminal prosecution like any confidence game.

The players in these games are often well-known to state law enforcement agencies. These players drift from scheme to scheme. In several instances we have seen boiler rooms populated with current commodity salesmen who formerly sold phony oil wells, or vice-versa. This will always be the case, and no amount of federal or state rules and regulations will turn these sales operations into honest businesses.

In summary, the effect of federal preemption has been to fire the cops in the midst of the crime wave. As to off-exchange transactions, the need for uniformity of regulation is overshadowed by the need for an effective criminal justice system. With all due respect to the federal court system, most criminal cases in white-collar crime as well as elsewhere have always fallen to state prosecutors. By denying state enforcement officials the jurisdictional tools to do their jobs, the public and the public's confidence in commodity investments have been damaged. The preemptive language currently contained in the Commodity Exchange Act has created a law enforcement disaster area in off-exchange commodity fraud, which must be corrected by legislative action.

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STATEMENT OF
THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, INC.

And

TOM KREBS
Director, Alabama Securities Commission

RICHARD D. LATHAM
Texas Securities Commissioner

ORESTES J. MIHALY
Assistant Attorney General in Charge
New York Bureau of Investor Protection and Securities

K. HOUSTON MATNEY
Maryland Securities Commissioner

MICHAEL UNGER
Director, Massachusetts Securities Division

Members of the Committee, we welcome this opportunity to present the views of the North American Securities Adminstrators Association, Inc., ("NASAA"), and of each of the members of this panel as the securities administrator of his respective state, on the inadequate performance of the Commodities Futures Trading Commission ("CFTC") in combatting commodities fraud and the related inability of our members to combat such fraud as a result of the preemption of state jurisdiction in Section 2 of the Commodities Exchange Act ("CEA").

NASAA is an association of state and provincial securities administrators from the United States, Canada and Mexico which, since 1918, has worked for investor protection. State securities commissioners are charged with promoting investor protection and regulating the securities markets in their respective jurisdictions. NASAA's activities involve cooperative efforts among its membership as well as with other law enforcement officials and certain federal agencies.

In this testimony we will address (i) the inability of the CFTC to combat commodities fraud through administration of the CEA; (ii) the preemption of a basic state police power in Section 2 of the CEA; (iii) the difficult enforcement problems faced by state securities administrators in attempting to combat commodities fraud; and (iv) the legislation proposed by the CFTC and NASAA's own legislative proposals.

The CFTC is charged with regulating the commodities and futures market, which includes maintaining a uniform regulatory system, to assure an orderly and competitive system of commerce. Investor protection comes within that charge, but policing the sales practices of agents soliciting public funds in commodities related transactions is not a primary mandate of the CFTC. In 1974, Congress granted exclusive jurisdiction to the CFTC in Section 2 of the CEA, thereby preempting federal securities laws and state commodities and securities laws. The basis for this grant of exclusive jurisdiction was the national, and often international, scope and effect of the futures markets. Participants in the futures markets, including producers, shippers and retailers, would have been hampered in engaging in a nationwide business if they were subject to non-uniform state regulation. The futures exchanges were deemed to be an integral part of the national economy and the contracts traded on such exchanges had to be uniform in order to be competitive.

Pursuant to its mandate, the CFTC has concentrated its efforts on developing an efficient national market system, i.e., a concentration on the hedging and speculative aspects of the futures markets, rather than on monitoring the investment by the general public in the futures markets. This public investment aspect of the futures markets has grown in substantial proportion since 1974, especially in the form of "boiler rooms" which specialize in the mass marketing of commodity-related instruments to unsophisticated persons who are unaware of the risks and potential losses inherent in such investments or the persuasive pressures being placed on them. This type of fraudulent activity in the futures markets impairs the integrity of the system and should not be protected by the granting of exclusive jurisdiction to create uniform regulation of the futures markets. The thievery and deception flourishing in these boiler rooms is that type of activity more effectively dealt with by local law enforcement officials, in particular, the state securities commissioners.

During the past seven years, the fraudulent boiler room business has continued to be a multi-million dollar industry, notwithstanding the regulation of the CFTC. The grant of exclusive jurisdiction to the CFTC and the concurrent preemption of the basic police power of states to protect their citizens from fraudulent activity constitutes a major failure of government in its establishment of regulation to protect investors. The CFTC has been incapable of curtailing the pervasive national commodities frauds alone. It is time for Congress to reconsider its 1974 decision to grant exclusive jurisdiction to the CFTC and return jurisdiction to the states.

Part of this failure to protect investors is a result of the methods utilized by the CFTC's Enforcement Division in combatting frauds, which does not emphasize criminal prosecution. The 1980 CFTC Annual Report reports that the Enforcement Division opened 777 and closed 689 investigative matters during the year. It also initiated 36 administrative proceedings and 19 injunctive actions of which a total of 30 actions were closed. The high number of investigative cases opened and closed gives no indication as to what matters were actually under investigation, nor does it point out that many closed investigative actions go into the backlogged hearing process where a resolution is months or years away.

The Annual Report mentions the initiation of 19 injunctive actions. Of those 19 actions, 15 are footnoted in the Report, but, of those 15 actions, 12 were brought against firms which had gone out of business *before* the CFTC initiated almost meaningless injunctive actions.[1] Injunctive actions filed against thieves, crooks and con men in federal courts are an ineffective response to fraud. These thieves, and the record supports this statement, usually set up a new corporation and continue their fraudulent operations in some other deferred delivery contract boiler room, while their lawyers drag out lawsuits by filing numerous dilatory motions.[2]

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[1] The caption for each of these matters would be *CFTC V.*: *v. Currency Specialists, Inc.*; *v. Michael Burke*; *v. First United Investment Corp.*; *v. Jefferson National Investment Corp.*; *v. Commercial Petrolea Internacional*; *v. R&M Precious Metals, Inc.*; *v. CoPetro Marketing Group, Inc.*; *v. Sterling Capital Co.*; *v. Annapolis Funding Company*; *v. Ashton & St. John's,.Inc.*; *v. Auric Equity Corp.*; *v. John J. Buterin*; *v. Trending Cycles for Commodities*; *v. Incomoco, Inc.*; *and v. Commodities America Corporation*.

The CFTC views this record of injunctive actions as demonstrating an aggressive and public-spirited investor protection program, but the members of NASAA view these injunctive actions as being too little, too late. State securities administrators are frustrated by this meaningless and ineffectve injunctive program while their constituents' savings are daily fed into boiler room fires on the altar of exclusive jurisdiction.

Preemption of state law in the commodities fraud area does not serve either the interests o legitimate commodities firms or the investing public. To date, the only persons to benefit from the exclusive nature of CFTC's jurisdiction are thieves, swindlers and boiler room operators. The national interest, commerce and government have been poorly served by the blind extension of exclusive jurisdiction to areas where there is no pressing national interest in uniformity or where concentrations of resources are best left outside of Washington, D.C. By what reasoning is it in the interest of the futures business for state authorities to be discouraged from chasing criminals and thieves who claim to be in the future as business when in fact they are not? Is there a genuine national purpose to be served by impeding local prosecutions of fraud and wrongdoings which incidentally touch upon commodities-related transactions under CFTC jurisdiction?

What had previously been a market reserved for sophisticated of state law preemption into a pitchman's paradise where unsophisticated investors are hyped by fast-talking salesmen with little or no knowledge of the industry. Despite the creation of the CFTC's exclusive jurisdiction over commodities transactions (or, more appropriately, because of it), boiler rooms touting commodity-related investments have burgeoned and prospered. Beginning with commodity options, continuing through silver and gold bullion sales, to deferred delivery contracts for crude oil and coal, and now with commodity pool frauds, boiler room operators have looted untold sums of money from our nation's citizens.

The scams and rip-off schemes continue unabated. Every year since the creation of CFTC, our country has experienced a major scandal involving commodity-related investments. Beginning with the infamous Lloyd, Carr and Company frauds in 1976 and 1977, each passing year has witnessed an unchecked migration of thieves, con artists and swindlers to the commodities investment area. If states are to give over their fundamental police powers to a unified federal system of regulation and enforcement, is it too much to ask that the federal system at least be able to protect the citizens of those preempted states?

2/ See Texas Cases involving United Petroleum Exchange Corporation and Robert Greenberg, and Sami Eisbart and National Coal Exchange.

The CFTC has condemned its own inability to regulate investment scams disguised as legitimate commodity firms. As Chairman Johnson said on September 25, 1981, "our small agency simply cannot act as a national fraud strike force."[3] His predecessor, Chairman James M. Stone, shares the realization that CFTC has not proven capable of policing those markets and transactions over which it has exclusive jurisdiction.[4] CFTC inability to provide investor protection is almost universally recognized by those enforcement-minded attorneys who have traveled quickly through the revolving door of CFTC's Enforcement Division.[5]

These public statements of CFTC's failures come as no news to state administrators or the many victims of unscrupulous salesmen of commodities-related investments. What does come as infuriating news is that CFTC, in spite of its many public admissions of inability to protect the unwary from the unscrupulous, continues its threats to file suit against those state administrators who seek the use of securities laws to attack boiler rooms. We are all aware that CFTC did intervene as amicus curiae challenging Arkansas' attempts to protect investors from commodity frauds.[6] The CFTC acted similarly to vacate an injunction obtained by the New York Attorney General's Office against a fraudulent commodities operator in New York. In 1981, in response to an inquiry from the Tennessee securities administrator concerned with CFTC non-action on cases involving Memphis boiler rooms in deferred delivery contracts in coal, CFTC officials admitted that there would be "a high risk of CFTC intervention" if Tennessee attempted to resolve the Memphis boiler room problem under Tennessee securities laws.

The state securities administrators became aware of the failure of the CFTC to act as a national police force soon after the grant of exclusive jurisdiction in 1974. With offices located only in Washington, D.C.; Chicago, Illinois; New York, New York; Kansas City, Missouri; Minneapolis, Minnesota and San Francisco, California, the CFTC is unable to adequately combat commodities frauds nationwide. In 1978, NASAA held hearings on commodities frauds and prepared a report of its findings. This report, which has been made available to the staff of this Committee, documents a state of affairs not unlike the present -- the inability of the CFTC to adequately protect investors and the need for an end to total exclusive jurisdiction. The last four years have acted as a continuation of that state of affairs and as further proof for the implementation of the conclusions drawn in that report which are similar to NASAA's present legislative proposals and constitute a reinvestment of jurisdiction of the states. The need for uniformity and stability in the national markets has little, if any, importance in the area of law enforcement where the primary goal is the protection of investors. In fact, the stability of the futures markets is threatened by the surging growth in the number of fraudulent commodities operators.

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[3] BNA Securities L. Rep. No. 622 (September 30, 1981), p.E-3.

[4] BNA Securities L. Rep. No. 630 (November 25, 1981), pps. E-1, E-2.

[5] The Business Week, July 6, 1981, "A Commodities Scar Rocks A Regulator", pps. 25-26.

[6] International Trading Ltd. v. Bell, 556 S.W. 2d 420 (Ark. 1977).

For 200 years, our nation had a federal system of government as opposed to a central government. Dual sovereignty was intended to buttress the system of checks and balances and provide, through the states, a level of government that was closer to the people while far enough away to avoid being captured by parochial interests. Today, the states and their citizens stand in danger of being eclipsed by the federal government they created. The past 50 years have witnessed, until quite recently, an increase in the concentration of financial and policy making responsibilities at the federal level. Erosion of the states' role, especially in the areas of consumer and investor protection, threatens to undermine a truly federal system of government.

These past few decades of governmental policy have reached their crowning achievement in the creation and maintenance of the CFTC's exclusive regulatory and enforcement powers. Nowhere in the entire federal system is there to be found greater evidence for the statement that all wisdom does not reside on the banks of the Potomac.

Conferring upon CFTC additional resources to fight fraudulent operators in the commodities investments is no answer to the present grave threats to investor protection. The structure and mandates of the CFTC are such that commodities frauds would still not be checked. Why else do those of us in state regulation witness the daily migration of thieves and con men to commodities investments? Why else has commodity investment become synonymous with fraud? In this era of federal deregulation and the new federalism, it is not the time to pour additional resources into a federal agency where the states securities administrators have the mechanism and incentive to act as a police force over commodities frauds. Authorizing additional resources to the CFTC's injunction program will not effectively curtail securities fraud. Commodities thieves are best defeated through prosecution in criminal trials in state courts in the state where their victims reside. The history of state securities enforcement has proven a very effective deterrent against fraudulent investment scams. Those sanctions must to be employed in the commodities fraud area.

Similarly, the solution to combatting commodities frauds, particularly as to off-exchange trading, does not lie with the National Futures Association ("NFA"), the self-regulatory organization ("SRO") for the commodity futures industry. While the existence of an SRO may provide much needed support to the efforts of a greatly understaffed CFTC, it would be extremely naive for anyone to assume that the NFA will be able to have any significant impact upon the massive off-exchange fraud that currently afflicts the nation, and, in fact, that would not be the role of the NFA. Its responsiblity will be to provide self-regulation over entities and individuals who submit themselves to the jurisdication of the CFTC via the registration process. In the securities realm, state securities administrators play an integral role in combatting fraud notwithstanding the existence of the National Association of Securities Dealers, Inc. ("NASD").

The overwhelming majority of such registrants are not the source of fraudulent activity. Rather, it is a distinct minority of registered firms and individuals who cause the greatest threat to the integrity of commodities trading and the public. A review of the CFTC's weekly bulletin will reveal the names of firms who time and time again appear as respondents in reparation proceedings brought by unhappy and cheated investors. We cannot, in good faith, assume that these firms, who push their operations and marketing to the fine edge of legitimacy, will be more responsive to an SRO than they are to the CFTC.

In considering the efficacy of an SRO as a substitute or supplement for strong state and federal regulation in the marketing end of commodities transactions we must be mindful that we are dealing with an industry that has consistently opposed almost every suggestion, idea or rule proposal that would benefit the public investor. For example, the suggestion that there be an investor suitability standard -- a standard long employed and accepted in the securities industry which provides an excellent self-policing mechanism for broker-dealer firms to guard against over-zealous sales personnel -- was vociferously attacked by industry and rejected by the CFTC. The major, if not only, impetus for the creation of a suitability standard lies in the protection of unsophisticated investors. There is no great regulatory burden in a rule which requires a commodities salesman to ascertain that a particular investment is appropriate for his client. The volatility and highly speculative nature of commodities trading compels the conclusion that only certain investors are candidates for such investments. If those who trade in securities, certainly a more conservative investing medium than commodities, must adhere to a suitability standard, why shouldn't commodities traders. The commodities industry's track record to date does not evidence a desire to openly advocate and push for strong investor protection standards in the marketing of commodities products.

It is difficult to assess the role the NFA will play in regulating the commodities industry. Since it is only recently formed, the NFA is years away from becoming a significant regulatory force -- assuming of course, that the CFTC and industry work to make it so. During the interim, the growth of the commodities trading industry will continue, and exotic and innovative products will keep appearing in the marketplace, as the investing public continues its search for relief from inflation. Without swiftly reinstating state jurisdiction, investors will be prey to thieves who take advantage of the CFTC's transfer of responsibility to an SRO not at its optimal operational level.

The CFTC's efforts at investor protection to date can only be characterized as a failure, and it is unreasonable to expect that an SRO controlled by industry and overseen by that same agency will do any better. Congress will do a great service to investors of this nation by providing adequate mechanisms within the federal regulatory scheme that enable state securities administrators to police the sales end of the commodities marketplace. Any reliance upon that task being properly undertaken by an SRO would be misplaced.

Despite the preemptive language in the CEA, state securities commissioners continue to be viewed by their constituents as the authorities to whom to report and expect action in connection with commodities frauds. The "horror stories" documented in these complaints are evidence that these boiler room operators do not deal with experienced futures hedgers or speculators, but rather the inexperienced investor who seeks to invest his life's savings. The states securities commissioners often take action on these complaints, notwithstanding the exclusive jurisdiction of the CFTC. We have made available to the staff of the Committee copies of complaint letters received by state securities administrators, affidavits obtained during the course of investigation and extracts from depositions or administrative hearings which eloquently portray the story heard time after time in recent years.

These "horror stories" of investor experiences, all of which are related in full, and summarized, in the Exhibits forwarded to the Committee , reflect the techniques utilized by boiler room operators From Georgia, Richard A. Card tells the story of his loss of $11,000 to National Coal Exchange in deferred delivery contracts. In Massachusetts, in proceedings against PMA Commodities, John Eyberg describes, as no lawyer or regulator could ever effectively articulate, his experiences with so called "Limited Risk Forward Contracts", involving a $4,000 investment. From Wisconsin, A. Stephen Jorgenson and Gerald V. Vande Hey describe their experiences with the L. B. Daniels Agency. From Maryland comes the story of "John Doe" who sufferred a $13,000 loss in coal contracts. Mr. Doe has requested anonymity in order to spare himself any further embarrassment, as his previous on-the-record cooperation with law enforcement officials has already resulted in substantial commitment of his time, marital discord, and public embarrassment in addition to the financial loss.

Certain common elements emerge from each of these stories regardless of the nature of the underlying investment. Whether the pitch is for coal, gold or silver, the success of the fraud depends upon:

(1) The hardsell by repeated telephone solicitations;

(2) The purported relationship of the selling company to some "reputable" exchange or other organization which will always remain happy to verify the legitimacy of the caller;

(3) The use of misrepresentations over the phone which are invariably contradicted by the documents supplied after the investor's money has been received;

(4) Insistence upon the use of wired funds, thereby giving the investor little time to reconsider the purchase;

(5) The apparent legitimacy of the actual written contract supplied which has been carefully drafted so as to involve neither the sale or a regulated commodity nor a security if the investment was, in fact, limited to the program described in the "contract";

(6) The use of a "maturity date" generally a year later so as to delay the time in which the investor will realize he has been taken.

Perhaps the most unfortunate aspect of these investor experiences is not the individual's financial loss but rather the devastating impact of these losses in the aggregate nationwide. While a review of countless "horror stories" across the country would probably yield a quantitative measure of the damage already done, how does one quantify the future loss to our legitimate financial marketplaces when these victims become so skeptical as to avoid future investments in economically productive activities?

We have also made available to the Committee eleven states' responses to Senator William B. Roth's letter requesting information on the level of commodities fraud since 1978, specific attempts by states to combat this fraud by civil or criminal action, the ineffectiveness of joint state-federal actions and Section 6d parents patrie suits and the ability to obtain necessary information from the CFTC for enforcement purposes.

These responses address and reflect many of the concerns contained in this testimony. They document an increase in commodities frauds cncurrent with the preemption of state jurisdiction including the appearance of repeat violators. The states have brought few, if any, civil or criminal actions for fear of CFTC intervention. The states have attempted to combat commodities fraud, notwithstanding preemption. They conduct their own investigations, including cooperative enforcement efforts through NASAA. Many states have attempted to deal with commodities fraud through the issuance of cease and desist orders in administrative proceedings. Some states have utilized publicity to combat commodities fraud through press releases, speeches, public hearings and commodities "hot lines". Certain securities administrators reflect the frustration of their citizens who are told that the administrator is preempted from acting against fraudulent activity and their own frustration at the CFTC's vigor in its claim of exclusive jurisdiction while investors continue to be robbed.

Certain responses addressed the difficulty the states confront in obtaining enforcement information from the CFTC. In particular, if a state or an investor wishes to obtain information on a licensed or registered person, the CFTC generally gives no information other than the fact that such person is or is not registered or licensed, notwithstanding such person's past violations. In addition, certain states, on receiving registration or licensing applications from the CFTC, find such applications to be misleading or incomplete, evidencing inadequate review in the registration process.

Certain responses concur in the conclusions drawn herein regarding the ineffectiveness of Section 6(d) and the inability of an SRO to adequately meet the challenge of commodities frauds. The states' responses reflect their belief that jurisdiction must be returned to the states.

In the 1978 amendments to the CEA, the states were granted, in new Section 6d, the limited authority to file civil actions in federal courts to enjoin violations of the CEA and of CFTC regulations. This authority has proven too limited to stop fraudulent commodity schemes which have come to the attention of state officials, and state attempts to enforce the CEA in federal courts in cooperation with CFTC has been ineffective.

A major failing of the current law is that Section 6d does not contemplate criminal prosecutions of commodities or securities violations by the state in a state or a federal forum. Thus, a principal weapon in the federal/state enforcement arsenal, criminal prosecutions by state government, is still absent. Criminal prosecutions constitute a major tool of many state securities law enforcement agencies, and its absence leaves a void which the current civil remedy of Section 6d cannot possibly fill. Emphasis on criminal prosecution is an area where state law enforcement programs have historically differed from those of federal agencies, in securities and commodities, as well as other regulatory fields. In addition, white-collar crime investigations and prosecutions are often not conducted under "general" antifraud laws under which the states must bring actions in state courts pursuant to Section 6d(7).

Instances where states have attempted to use the injunctive remedy provided in Section 6d have not been productive. For example, the Texas Securities Board recommended one case for injunctive action in federal court, through the Attorney General of Texas and the CFTC, after a securities investigation in early 1981 revealed violations of federal commodities laws. The case was filed jointly by the State of Texas and the CFTC in January 1981. A Temporary Restraining Order was obtained against International Bullion Clearing Corporation and Robert Greenberg. Since that time, Greenberg's lawyer has used a vast assortment of delaying tactics available in federal court to keep that lawsuit in limbo and keep his client from having to pay fines and restitution for violations of the Texas Deceptive Trade Practices Act which were alleged in the same lawsuit.

While the federal court system is an appropriate forum for federal agencies to pursue their regulatory policies, it is not the appropriate forum to carry out the local antifraud programs of state governments. Rather than litigating problems of national interest with national exchanges and multi-national companies, state enforcement programs have tended to concentrate on the confidence games and white-collar crime problems suited for swift state court actions and criminal prosecutions. Unfortunately, injunctive actions against white-collar criminals filed in federal court are usually ineffective. The crook may set up a new corporation and continue operations in some new scam while his lawyers drag out lawsuits by filing a myriad of motions. There are numerous examples of this, but two come quickly to mind.

CFTC filed an injunctive action against United Petroleum Exchange Corporation and Robert Greenberg to stop the sale of fraudulent futures contracts in crude oil. While that action was in its early stages, Greenberg set up International Bullion Clearing Corporation to sell deferred delivery contracts. The CFTC and the State of Texas filed suit against International Bullion Clearing Corporation in January 1981. A hearing on Preliminary Injunction was finally begun on February 8, 1982, after numerous delays. To date there has still been no resolution of this case, though the Defendant remains under a Temporary Restraining Order.

The second instance involves Sami Eisbart who was sued by the CFTC for the sale of fraudulent futures contracts in crude oil. While the lawsuit was pending, Eisbart was instrumental in setting up National Coal Exchange which has allegedly solicited millions of dollars from investors. CFTC, after a long investigation, sued the National Coal Exchange.

The above illustrations indicate that federal courts are not the appropriate forum in which to conduct the white-collar crime programs best suited to state criminal prosecutions. But it is also important to note that the types of actions contemplated for state officials under Section 6d are inappropriate programs for state enforcement efforts. State legislatures seldom willingly appropriate funds for state officials such as attorneys general or securities administrators to enforce federal laws and regulations, as contemplated in Section 6d. Without authority to pursue violations under state law, state officials such as securities administrators lack authority to expend their resources on commodity investigations. Further, an integral weapon in the state enforcement arsenal (though it is absent in current commodity regulation) is criminal prosecution, and many state attorneys general have no authority under their state laws to institute criminal proceedings. Commodities frauds have been investigated in the past by securities administrators because of their similarity to securities frauds, and these frauds would be best investigated and prosecuted by the local officials with local powers of prosecution under local statutes. In short, the provisions of Section 6d place the wrong program (white-collar crime enforcement involving commodities) in the wrong forum (federal injunctive proceedings).

The Supreme Court is presently considering whether or not there is a private right of action under the CEA. Presently, the Circuit Courts are split 4 to 3 for a private right of action. Without a private right of action, defrauded investors must rely on the CFTC's reparations procedures. Neither of these methods are effective in combatting the high level of securities fraud. Presently, the CFTC's reparations division has a backlog of over 2,000 cases and in general a case takes over 40 months to its completion. Private rights of actions impose a burden on a defrauded investor who, after already losing his life's savings, must expend time, energy and expense in bringing suit. This can be difficult in the case of a company or operator which has closed up its shop and started anew in a different location with a different name. If the states are granted jurisdiction over the enforcement of commodities frauds, they could bring criminal actions against the fraudulent operators to put them out of business. Private parties could seek to join their claims for damages to such suits or utilize the state's case in presenting his own, if private rights of action are found to exist under the CEA.

Presently, the states have no authority to register commodity operators of any sort. This prevents commodities operators from having to comply with 50 different registration procedures in the states as do registered broker-dealers. NASAA and the NASD are in the process of implementing a Central Registration Depository ("CRD") which will permit a broker-dealer to register with the Securities and Exchange Commission and all the states with one filing and one fee payment. Notwithstanding the progress made with the CRD, state securities commissioners in general do not seek the authority to register commodities professionals. Still, the present system is defective in two respects: the states cannot readily obtain information regarding persons registered with the CFTC who are being investigated for possible fraudulent activity, and these registered persons continue to operate fraudulently as the CFTC is unable to adequately police the persons registered with them. NASAA has proposed, as part of its legislative package, which is discussed below and attached hereto, that certain commodities professionals be required by the CFTC to indicate on their registration filings in which states they are operating. Such information would be forwarded by the CFTC to the appropriate state official. The NASAA proposal would also authorize the appropriate state official to petition the CFTC for the suspension or revocation of the registration of those commodities professionals included in the proposal, and the CFTC would be mandated to promptly act on such petition. Such a procedure puts a minor, if any, regulatory burden on industry and at the same time enables those authorities closest to the fraudulent activities, the state securities administrators to bring such activities to the attention of the CFTC and possibly assist in the CFTC's investigation.

NASAA has submitted to the Committee with this testimony seven proposed amendments to the CEA which are attached hereto. The first of these amendments would amend Section 2 so as to define the scope of the exclusive jurisdiction of the CFTC in those areas in which there is a clear national interest. This includes the registration of contract markets or clearing houses, the registration or licensing of commodity futures commission merchants, floor brokers, dealers agents or salesmen and those transactions traded or executed on a registered contract market.

The second proposed amendment establishes the registration-related authority discussed above. Pursuant to this proposal, the CFTC would inform the appropriate state officials of those registered futures commission merchants, commodity trading advisors, commodity pool operators and associated persons thereof operating within their state. In addition, the states would be authorized to petition for and present evidence sustaining a suspension or revocation of any such person's registration. This amendment would not grant any authority to the states over the actual registration process.

The third proposal would expand the jurisdiction granted in Section 6d(7) of the CEA so as to permit states to bring state administrative and court proceedings under general, commodities or securities antifraud statutes of the state. Presently, the states can only bring actions in state court under general antifraud statutes. The ineffectiveness of that limited authority has been alluded to above. The reinstatement of jurisdiction over exchange and off-exchange transactions as to antifraud matters would restore a basic police power enabling the states to protect their citizens from fraudulent and illegal conduct and would improve the integrity of the national futures market.

The next proposed amendment is, in substance, similar to the CFTC's proposed amendment to Section 8(e). The purpose of both amendments is to authorize the CFTC to share investigative information with the states for enforcement purposes. The sharing of information has proven to be an effective enforcement tool in the enforcement efforts of the Securities and Exchange Commission and the state securities administrators. In connection with this amendment, NASAA also proposes an amendment to Section 12(a) of the CEA which specifically requires the CFTC to cooperate with the states by sharing enforcement information.

NASAA's sixth proposed amendment is almost identical to the CFTC's proposed amendment, which adds a new subsection (e) to Section 12 of the CEA. This amendment grants concurrent jurisdiction to the states and to federal authorities other than the CFTC over off-exchange transactions, which are the major source of fraudulent activity, and over persons who fail to register with the CFTC as required. The concurrent jurisdiction granted by this amendment goes to both regulatory and antifraud matters. The language of subsection (3) of NASAA's proposal differs from the CFTC's. The purpose of that change is to place the burden on the unregistered person to negate his duty to register rather than requiring the state official to prove such a duty to register in its case in state court, which may, thereupon, remove the case to federal court as such is a decision of federal law.

NASAA's final amendment grants the states concurrent jurisdiction as to the registration of persons dealing in leverage contracts. Presently, leverage contracts are another source of fraudulent activity and the number of persons who would be required to register would not be so great as to burden industry with substantial expenses. In lieu of authorizing the states to register persons dealing in leverage contracts, NASAA proposes that such persons be included in the amendment regarding notification of operation in the state and state petitioning for revocation of registration.

Congress cannot delay action in this area as thieves continue to loot unsophisticated investors. In 1974, Congress granted exclusive jurisdiction to the CFTC and "the police force was cut from fifty to one in the middle of the crime wave."[7] As fraudulent activity flourished, Congress enacted Section 6d in 1978. This effort has proved futile. Jurisdiction over commodities matters must be returned to the states for the sake of the investing public.

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[7] Report of the Commodities Task Force of the North American Securities Administrators Association, April 1978, p.8.

NASAA appreciates being invited to testify in order to give its views on the CFTC's ability to combat fraud and would be pleased to furnish any other information the Committee deems necessary.

North American Securities Administrators Association, Inc.
Proposed Amendments to the
Commodities Exchange Act ("CEA")
and Commentary

1. Section 2(a)(1) of CEA is amended by

   (a) deleting the word "exclusive" after the phrase "Provided, That the Commission shall have"; and

   (b) inserting the following after the phrase "pursuant to section 19 of this Act;"

   > "...and such jurisdiction shall be exclusive as to options transactions, as specified in Section 4c of this Act, and as to commodity futures contract market or clearinghouse registration and as to commodity futures commission merchant, floor broker, dealer, agent or salesmen registration or licensing where such accounts, agreements, and transactions involve contracts for sale of a commodity for future delivery, traded or executed on a contract market designated pursuant to Section 5 of this Act;"

Commentary

The purpose of this amendment is to define the scope of the exclusive jurisdiction of the Commission. Essentially, the need for exclusive federal jurisdiction lies in those transactions on the national commodity market. This amendment grants exclusive jurisdiction to the Commission over the national commodity markets and over the commodities professionals dealing in those national markets to the extent that such professionals register with the Commission. If they fail to register then they are subject to concurrent jurisdiction under number 6 below. This amendment also grants exclusive jurisdiction to the Commission over the contract agreements traded on the exchanges. The exclusive jurisdiction granted by this amendment is limited to regulatory matters insofar as States are granted concurrent jurisdiction in anti-fraud matters under the proposed amendments to Section 6d(7) in number 4 below.

2. The CEA is amended by adding after Section 4p thereof the following new subsection:

   > "4q. The Commission shall require all futures commission merchants, commodity pool operators, commodity trading advisors and associated persons thereof, who are registered or regulated under Section 4d, 4f, 4k, 4m, 4n, 4p or 8a of the Act, to indicate to the Commission in which States they are operating as a floor commission merchant, commodity pool operator, commodity trading advisor or associated person thereof; and shall notify the appropriate official in those States so indicated of such registration for notice purposes. Any appropriate official from a State may petition the Commission to suspend or revoke the registration of any floor commission merchant, commodity pool operator, commodity trading advisor or associated person thereof who is operating within that State, whereupon the Commission shall promptly ascertain whether cause for suspension or revocation exists under Section 8a, paragraph 2(B) or (C) and, if it does exist, proceed under Section 6(b)."

Commentary

The purpose of this amendment is to statutorily grant a means by which State officials can investigate floor commission merchants, commodity pool operators, commodity trading advisors or associated persons thereof against whom they have received complaints and can seek to have such persons' registration suspended or revoked without actually establishing a registration system on the State level. The State official would present evidence sustaining a suspension or revocation to the Commission in a petition requesting such action and the Commission would be required to promptly act upon such petition. In essence, this amendment extends the investigatory powers of the Commission in registration and licensing matters.

3. Section 6d(7) of the Act is amended by

   (a) by striking the word "section" and inserting the word "Act";

   (b) inserting the words "or in a State administrative proceeding" after the words "in State court;" and

   (c) striking "." and adding "or of any general,commodities or securities anti-fraud statute of such State, except that the Commission shall have exclusive jurisdiction over a contract market, clearinghouse on floor broker."

Commentary

The purpose of this amendment is to grant the states concurrent jurisidiction with the Commission with respect to anti-fraud matters as to both exchange traded contracts and off-exchange transactions. This expanded jurisdiction, especially as to exchange traded contracts for off-exchange concurrent jurisdiction is granted in number 6 below, restores a basic police power of the states to protect their citizens from fraudulent and illegal conduct. Its scope is limited to State statutes dealing with such conduct.

4. Section 8(e) of the Act is amended by

   (a) inserting in the third sentence "or of any department or agency of any State after "of the Government of the United States";

   (b) inserting in the fourth sentence "or State" after "to any Federal";

   (c) inserting in the fourth sentence "or the laws of any State" after "of the United States"; and

   (d) inserting in the fourth sentence "or the State" after "or the United States".

Commentary

The purpose of this amendment is to authorize the Commission to share investigative information with the States for use in Federal proceedings under Section 6d of the Act or under State proceedings under Sections 6d(7), 12(e) and 19(e). Without the sharing of such information the States cannot effectively investigate fraudulent activity, especially under the parens patrie actions under Section 6d.

5. Section 12 of the CEA is amended by adding in subsection (a) after "person" the words "and shall specifically cooperate with such department or agency by furnishing information necessary for enforcement purposes."

Commentary

The purpose of this amendment is to mandate cooperation by the Commission with State departments or agencies in connection with the sharing of information for law enforcement purposes. See Commentary to number 4 above regarding the need for States to have access to such information.

Section 12 of the CEA be further amended by adding subsection (e) as follows:

> "(e) Nothing in this Act shall supersede or preempt: (1) any Federal criminal statute; (2) any Federal or State statute, including any rule or regulation promulgated thereunder, that is applicable to any transaction in or involving any commodity, product, right, service or interest which is not conducted on or subject to the rules of a contract market or subject to regulation by the Commission under 4c or 19 of this Act or (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person who, but for his failure or refusal to obtain registration or designation under the Act, would be under the exclusive jurisdiction of the Commission except as otherwise provided in subsection 7 of Section 6d of the Act. The Commission is authorized to refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action or proceeding as the department or agency shall deem appropriate."

Commentary

The purpose of this amendment is to specifically grant concurrent jurisdiction with the Commission to other Federal agencies and to State departments or agencies as to regulatory and anti-fraud matters as to off-exchange transactions and as to persons who fail or refuse to obtain registration or designation under the Act. This language is similar to that included in the Commission's legislative package except that subsection (3) is drafted differently in order that the duty to obtain registration under the Act need not be proved in State court. Rather, the lack of registration will create the concurrent jurisdiction, though the unregistered person may contest its supposed duty to register.

7. Section 19 of the Act is amended by adding the following new subsection:

> "(e) Nothing contained in this Act shall prohibit a State from requiring the registration of persons soliciting or accepting orders for the purchase or sale of the standardized contracts described in subsection (a) of this Section and from promultating rules and regulations with respect thereto insofar as the exercise of such jurisdiction does not conflict with any provision of the Act or rule, regulation or order thereunder.

Commentary

The purpose of this amendment is to permit the States to register those persons involved in the marketing of standardized leverage contracts. The registration requirements created under this new subsection cannot conflict with the Act or any rules, regulations or orders thereunder. In lieu of this amendment, the persons covered by this subsection should be added in Section 4q as proposed in number 4 above, to include them in the notice from and petition to the Commission procedure created therein in connection with registered persons.

PREPARED STATEMENT OF MICHAEL A. COLLORA

My name is Michael A. Collora. As background to my remarks, I should say I was with the United States Attorney's Office in Boston, Massachusetts from 1973-1981, and in the last two years was chief of the special prosecutions/frauds unit in the U. S. Attorney's office. During that time I prosecuted a large commodities fraud case known as Lloyd Carr in which 12 persons were convicted of mail and wire fraud; I also prosecuted the Bartex petroleum fraud in which 7 principals were convicted. I also supervised the investigation and prosecution of several other commodity-related schemes. I am now in private practice with the law firm of Hemenway & Barnes and am the temporary receiver of the assets of Boston Trading Group, Inc. and Northeast Investment Services, Inc., both of which were registered commodity pool operators and commodity trading advisers with the CFTC.

I have observed that since 1975 the area of commodities has been plagued with an influx of "confidence" men, "boiler" shops, fraudulent dealings, and enormous losses to the investing public. The CFTC, due to inadequate manpower, has been unable to police the industry sufficiently and control off-exchange trades, futures commission merchants, commodity advisers and commodity pool operations. A few examples from my personal experience should help this Committee understand the magnitude of the problem.

The Lloyd, Carr and Bartex Prosecutions

(a) Lloyd, Carr

The Investigation

Alan H. Abrahams, using the name James Carr, opened Lloyd, Carr & Company in Boston in July, 1976 and from then until January, 1978 raised $28,000,000 selling London options. Despite a lengthy criminal record and having escaped from a New Jersey prison, Abrahams succeeded in obtaining a license in

1976 for his company without investigation by the CFTC. Lloyd, Carr charged commission of 50-500% over the cost of the option in London; as a result 97% of its customers lost money, with 83% losing everything; even those due money had difficulty obtaining it. Boiler room antics were raised to a high level including gongs, pressure tactics on customers, physical threats and numerous questionable salesmen's incentives.

The investigation by the U. S. Attorney's office commenced in January, 1978; we started with a search warrant executed by the FBI and proceeded to conduct lengthy grand jury sessions, calling over 100 witnesses. Eventually Abrahams and 11 of his officers and salesmen were indicted; all were convicted and 5 received jail terms.

Lloyd, Carr & Co. went into receivership and eventually bankruptcy. The U.S. Attorney's office used a newly negotiated Swiss treaty to freeze $1.7 million of Abrahams' monies in Zurich; the receiver, with the help of our office, obtained control over $2 million in Bermuda banks. The suddenness of the search plus the quick unmasking of Abrahams were obviously of great help in freezing this money.

Problems

Obviously, the CFTC should have had the legislation and manpower to monitor the London options markets. Numerous other mini-Lloyd, Carrs flourished in Boston, New York and Chicago causing many to lose millions. Obviously, too, the CFTC moved rather slowly against Abrahams, and the court in Boston did little to assist the agency. A CFTC civil case opposing registration of Lloyd, Carr took 10 months with Abrahams continually selling during this period. Stricter registration with the burden on the registrant to satisfy the requirements is absolutely necessary.

Rudolph Wolff, Lloyd, Carr's broker in London, offered minimal cooperation to authorities, no doubt due to a fear of civil suits. It should be a requirement that any clearing company with a public market in the United States should automatically subject itself to jurisdiction here.

(b) Bartex/Ramco

The Investigation

In order to avoid CFTC registration requirements, in 1979 a number of companies attempted to sell an interest in the physical commodity, which is exempt from regulation. These companies claimed they were not selling futures contracts but cash forward contracts for actual delivery. These companies were assisted by the failure of Congress to define a futures contract in the Commodity Exchange Act.

The CFTC was slow to investigate these companies. Bartex Petroleum Company in New York, run by two ex-felons, sold a cash forward contract in oil, purportedly owned by Commercial Petroler Internacional (CPI) in Panama. These boiler rooms raised some $3 million in 5 months before the CFTC and the State of New York obtained restraining orders in early 1980. Little if any money was ever recovered.

Due to the press of business created by the overwhelming number of boiler rooms in Manhattan, that office was unable to prosecute Bartex; thus, the U. S. Attorney's office in Boston assumed the main thrust of this investigation and in November, 1980, the managers of the Boston office, together with the principals in Bartex, International Petroleum Exchange & CPI were indicted and convicted of mail fraud. All went to jail. The investigation showed no oil was ever puchased; in fact it was clear from the literature that the principals had little understanding of the oil market. Aliases were used by one principal; it was ironic to note the similarities between the oil literature used in Bartex and that used in other commodity operations run by these principals in previous deals.

Problems

As with many of these boiler rooms, due to a slow moving civil investigation, virtually all customer money was lost.

Unfortunately, there were no capitalization requirements and no segregated accounts. The use of offshore accounts in Panama and other countries impeded the investigation, both civilly and criminally.

No doubt a clear definition of a "futures contract" and its progeny would have been of assistance.

The Current Situation

When London options could no longer be sold in 1978, the "telephone boys" switched to precious metals, then, in 1979, to oil and gas, later strategic metals and now into commodity pools. In order to stop this, several solutions are possible.

(a) More State Power

The states have limited powers and limited interest in this area, particularly if no sales are made in their jurisdiction. Obviously, however, since the CFTC has a limited staff, the states should be encouraged to fill that gap if they are willing. Concurrent jurisdiction will help here, particularly in the civil area. However, the use of multi-state operations, offshore bank accounts, and false names complicate matters, and the bigger swindles will no doubt have to be investigated by federal agencies.

(b) Revision of the Commodity Exchange Act

Situations where a convicted felon such as Abrahams ends up running a commodity house are not isolated. Lloyd, Carr personnel after conviction have continued to engage in other boiler room operations. A recently defunct company in Boston entitled U. S. Investment was run by Gerald Kent using the name Harold Kent; our office prosecuted and convicted him for mail fraud in 1976 in Boston. He is nowhere to be found today.

It follows that the licensing and checking of salesmen must be more stringent; rigid requirements must be established and penalties against houses employing convicted felons must be assessed.

(c) Commodity Trading Advisors

There should also be more stringent limitations on commodity trading advisors and commodity pool operations. Recently I was appointed the receiver of two commodity pool operations, Boston Trading Group, Inc., and Northeast Investment Services, Inc. Both allegedly were churning their clients' accounts without regard to the clients' interests. The principals have drained the company's accounts and the customers have received minimal returns. Millions have been siphoned off. This occurred at a time when the CFTC was investigating the companies.

While the agency will have to move faster in order to preserve assets it is obvious that a license to act as a CTA or CPO may be simply a license to steal. It appears both types of registration serve no useful purpose.

Conclusion

Fraud is rampant in the commodities area. The Commodity Exchange Act should be strengthened, stricter registration of salesmen is necessary, and abolition of certain other types of commodity companies dealing with the public may be required. The states should be given concurrent jurisdiction. Otherwise, the horror stories heard by this committee will only be repeated.

* * * * *

PREPARED STATEMENT OF BOBBY HOWELL

My name is Bobby Howell. I have come before the Subcommittee to describe my four years of experiences in working in and operating commodity boiler room operations. I am presently serving a five year sentence in a federal penitentiary for my involvement in such a boiler room operation.

With me is Dan Sledd. He was convicted with me.

I first became involved in commodity sales in January of 1977. For the seven years prior to that, I had successfully sold life insurance and real estate. The real estate firm I was working with went out of business in January of 1977 and I started selling London options with a firm known as Franklin Commodities in Atlanta. While with Franklin Commodities I applied for and obtained an associated person's license from the CFTC. In early summer of 1977 I and three other people formed a commodity firm known as Lincoln Federal Investment Company. We obtained a license from the CFTC for this firm in July 1977.

Lincoln Federal was immediately successful and generated significant cash flow for us. However, in October, 1977 the firm had to comply with the CFTC's double segregation requirement wherein 90% of our customer's premium funds had to be segregated in an escrow account. We managed to circumvent this requirement by having our customers sign a waiver form wherein they waived this requirement with respect to their personal account.

Lincoln Federal operated from the spring of 1977 to the spring of 1978. During that period, we sold over $2 million in contracts to between 300 and 400 customers.

To cover it saies, Lincoln Federal bought its options from a firm known as Commodity Analyses. We charged our customers approximately twice the cost of the options to us. We had fifteen salesmen situated in a plush office, and obtained our leads from an industrial directory. Many of our calls were "cold" calls out of that directory and many were quite successful. We told the salesmen to avoid calling attorneys as we knew they were inclined to bring suit if they lost money.

The selling of options was banned by the CFTC in the summer of 1978. During the spring of 1978 Lincoln Federal had been investigated by the CFTC on charges of keeping inadequate records (our records had not been posted since January 31, 1978) and for failing to segregate 90% of customers' funds. As a result of this investigation, Lincoln Federal voluntarily ceased business under a CFTC consent decree in May of 1978. When we closed our doors, we owed over $100,000 to our customers; we were put into receivership.

Immediately after we closed down, I was introduced to what were called "deferred delivery contracts". Mr. Sledd and I bought a shell company in Grand Cayman with a Cayman attorney as the owner of record. Using this shell company, we formed a company called First United which operated under the guise of being a seller of physical gold and silver obtained for "deferred delivery". By late September 1978, when we closed down First United, we had raised over $230,000 from 40 customers using eight to nine salesmen.

First United sold a locked in price contract for gold and silver to be delivered in from 92 to 180 days. The contract price was non-refundable and included storage, insurance, interest and commissions, and there were no margin calls. Our agreement with our customers was that delivery could not take place before the contract expiration date.

Investors were told that the metals they purchased was held in a vault in the Bank of Nova Scotia in Grand Cayman and that they would get a certificate of ownership from the bank which would identify the lot of metal they owned. This was pure fabrication as the Bank of Nova Scotia handles all of its gold and silver storage out of its Toronto offices, handles only cash purchases, and only issues certificates for full paid contracts. Our proceeds from our First United operation were carried directly to our shell company's bank account in the Cayman Islands.

After internal conflicts developed, Bobby Sledd and I closed down our First United operation and moved to Clearwater, Florida where we set up Jefferson National Investment Corporation. We chose Clearwater as it had one of the few direct flights to Grand Cayman. The company was opened in October 1978; ironically it was actually next door to the FBI's resident office in Clearwater. Jefferson National held itself out as selling actual metal, when in fact we were only selling options. We closed the one Cayman company we had set up for First United and immediately opened another company known as European International

Depository Limited. Our promotional material held out EID as being a very old reputable and unasailably solvent precious metals depository in Geneva, Switzerland. We held Jefferson National out as being EID's sole distributor in the United States and told people that EID held all of the physical metal sold by our company.

From September 1978 through September 1979, JNIC sold approximately $1,317,500 worth of contracts to 156 investors in 26 states. When we finally closed our doors in November, 1979, we had paid back $364,218 to 54 preferred customers.

For the most part, we avoided repaying clients for contracts when they came due by rolling these contracts over into new contracts, recomputing entry prices so that the investors "lost their investment" or by simply withholding payment in the hopes that the investor would not pursue the issue.

The following table represents a brief financial summary of JNIC operations:

Financial Summary

SALES OF JNIC			1,317,500
Checks to Howell	45,319		
Checks to Sledd	39,213		
Personal Expenses	101,450		
Checks to Cash	200,190		
Deposit to Caymans Bank	17,400		
Total Withdrawn for personal use		457,572	
Returned to Customers		364,218	
Legal Fees to Receiver		35,710	
Other Expenditures		460,000	1,317,500

In our initial operations with Jefferson National we purchased some metal as a hedge for our customers; however, in November of 1978, one month into our operation, we ceased covering our customer's orders and any repayments we made to customers were obtained from new money coming in.

In November, 1979 the FBI entered our premises with a search warrant and we were closed down. The FBI had obtained the search warrant based upon a series of telephone conversations between several of our salesmen and an undercover FBI agent in Chicago who had called in as an investor.

Based upon the FBI search warrant and subsequent investigation my partner and I were convicted in Chicago of commodities fraud and other violations relating to our operations and as a result are now serving sentences in federal penitentiaries.

PREPARED STATEMENT OF EDWARD T. DANGEL, III

My name is Edward Dangel; I practice law in Boston, Massachusetts, and am the court appointed equity receiver for the defendants in a case entitled, CFTC v Commercial Petrolera, Internacional, S.A., S.D.N.Y. No. 80-0689. Although this case was commenced by the CFTC in February, 1980, it was not until October, 1981 that I was finally appointed as federal receiver. Therein lies the biggest problem with this receivership proceeding: DELAY. There was delay in moving against the defendants, delay in freezing bank accounts, delay in pursuing the individuals responsible for this particular scheme and delay in appointing a receiver who could attempt to recover monies for the defrauded victims of the scheme. As a result, this receivership's potential for recovering back funds for those who were victimized by the defendant's wrongdoing is limited.

By way of background it is helpful to know a little bit about the scheme itself. It was concocted by two men, Richard Waggoner and Edwin Bederson during the summer of 1979 in order to cash in on the oil shortage and energy crisis fears of the public. They in essence decided to sell imaginary crude oil for future delivery. In view of the rising price of oil they felt that people would "buy" 1000 barrels of oil at a fixed price today for delivery or resale at a much higher price in one year. Within the framework of this plan to "sell" oil, they developed an elaborate corporate maze which served the dual purpose of funneling money out of the country and befuddling anyone who attempted to question the legitimacy of the enterprise.

At the apex of the structure was Commmercial Petrolera Internacional, S.A., (CPI) a Panamanian corporation owned by Richard Waggoner and his Panamanian associates. Although it was nothing but a corporate shell, Waggoner was able to manufacture some credibility through three devices. First, he invented the story that CPI was formerly an Iranian corporation with millions of dollars in assets. This fact was attested to by an Iranian accountant's "certified" financial statement. (Unfortunately, the Iranian revolution earlier in 1979 made it impossible to trace this accountant or the financial information). Second, he persuaded a local bank official in Panama City to provide bogus verification of CPI's banking activities. And finally, he obtained a Dun and Bradstreet report on CPI in Panama City, again by "persuading " a secretary to telex, under the D & B name, this financial information to Edwin Bederson in New York. While this telex was not the actual D & B report, CPI used it as such.

Armed with the "financial statement" of CPI, the bank letter of reference and the D & B "report", Bederson, through his newly created International Petroleum Exchange, Inc. (IPE) in New York, was ready to execute the next step in the scheme. By August of 1979 IPE had entered into a contract with CPI whereby it was to act as the exclusive agent the United States for the sale of CPI's "oil". IPE, in turn, contracted with another new corporation, Bartex Petroleum Inc., whose principals included James Morse and Kenneth Levin. Bartex was to provide the marketing services for IPE. Both Bartex and IPE then found a New York attorney who, for $300, wrote an opinion letter stating that the sale of these crude oil contracts was subject to neither the securities laws nor the commodities laws of the United States. With this opinion, as well as the previously mentioned "documentation" — all of which gave the scheme the appearance of legitimacy — Bartex began to operate as a franchisor and set up sales companies who conducted "boiler room" operations throughout the country. At the height of the scheme in late 1979 there were approximately twenty-three of these "selling companies", each making hundreds of telephone solicitations every day of the week. Each of these selling companies, although separately incorporated, was put in operation by Bartex and did business in accordance with Bartex policy.

A typical selling agency would operate out of one or two rooms filled only with desks and telephones. The employees spent six to eight hours per day making "cold calls", i.e. unsolicited calls to individuals whose names and numbers had been purchased from a mailing list. The sales techniques were uniformly "high pressure" and were designed to convince the prospective purchasers that they were fools unless they purchased these contracts.

The sale itself involved an alleged purchase of 1000 barrels of crude oil for delivery or resale in one year. In fact, there was no oil to back up the purchase. For the right to purchase the imaginary barrels of oil, the customer paid a non-refundable "acquisition fee" of between $5,000 and $12,000. On the day of the purchase the "strike price" was established, approximately $32 to 35 per barrel during the latter part of 1979. Depending, thus, upon the amount of the acquistion fee, the customer had to hope for a $5 to $12 per barrel rise in the spot crude oil market over the next twelve months just to break even. Only after such a rise would the customer be entitled to a return on his investment.

Of the acquisition fee collected from a customer, the selling company retained approximately 50% as its commission and wired the other 50% to Bartex in New York. Given the high overhead involved in maintaining telephone sales throughout the country, a good portion of the selling company's "cut" was spent on operating expenses. Upon receipt of funds Bartex would retain approximately one-half and transfer the other half to IPE in New York. IPE then transferred approximately 75% of the receipts to CPI in Panama. All of these transactions happened within days. A customer's $10,000 investment was quickly carved up along the way and approximately $2,000 of it ultimately left the country. There were a few variations and twists in this general outline, but the foregoing serves to describe the highlights of the scheme. To give you an idea of the magnitude of this scheme, it now appears that more than 600 customers invested approximately $3.6 million, of which practically nothing is presently available to return to investors.

The scheme was operating at full force by October 1979. And by October the CFTC and innumerable state regulatory agencies were receiving calls from potential customers inquiring as to the legitimacy of this operation. From what we have been able to learn, the CFTC was usually unable to provide much guidance, because the activities of the defendants were not registered with the CFTC. By perseverance (and finally dialing the correct telephone number) a customer could find out whether a specific individual was registered with the CFTC. The caller could not learn, however, if this crude oil contract was, in fact, subject to the jurisdiction of the CFTC or a legitimate commodities investment.

State, rather than federal, regulatory agencies were the first to act. Montana and Alabama, for example, issued cease and desist orders enjoining Domestic Oil, Inc., a New Jersey selling company, from making telephone solicitations into their states. But enforcement of such orders was impossible. In Massachusetts, California and New York, where selling companies were actually located, the state authorities had more success. In Massachusetts one such company was closed down and put into receivership in December of 1979 and another was put out of business in January of 1980. In both instances, however, most of the assets had disappeared before the receivership. Similar results were obtained in California. In New York, the Attorney General moved swiftly and, by mid December, obtained a preliminary injunction against Bartex, IPE and CPI. Bartex' funds were temporarily frozen in New York bank accounts. Unfortunately Bartex merely moved across the river into New Jersey and continued to run its business; when the New York Court allowed a one-day hiatus on the garnishment of accounts, all of Bartex funds disappeared.

The New York office of the CFTC was also investigating this scheme as early as December, 1979 and, in fact, Bartex had co-operated to the extent of turning over to it all its books and records. Furthermore, the Attorney General of New York was sharing its information with the CFTC. Nevertheless, the CFTC could not act until February 4, 1980, well after the various defendants had taken their ill-gotten gains and closed-up shop. Although the federal court ordered, in essence, every bank account frozen, most of the funds were long since removed from the court's jurisdiction — most of the funds apparently in Swiss and/or Panamanian bank accounts. In retrospect, it appears that the CFTC's job was partially completed on February 4: the crude oil sales scheme was over.

However, in another respect a job, which was equally important and even more difficult still required action. All of the 600 plus individuals throughout the country had been swindled out of sizeable amounts of money. The Commodities Exchange Act provides little or no explicit relief for victims of off-exchange fraud. Furthermore, an investor usually has neither the resources to pursue, nor the damages to justify, a large scale lawsuit. While there is no statutory provision for it, a receiver, appointed with broad equity powers, is in a unique position to represent the interests of the victims, while at the same time functioning as a court-appointed official. A receiver armed with a judgment against defendants has the inherent power to bring proceedings in aid of judgment which theoretically, at least, permit quick court action to reach and recover assets of wrongdoers. That is, the assets can be reached if they can be found.

It is essential that a receiver be provided with adequate support in order to pursue the ultimate goal of forcing the wrongdoers to disgorge assets to the victims. First, the receiver needs funds for fees and expenses. It is expensive and time consuming to pursue assets through various entities, over various state and international boundaries. If the lead time is long, this is increasingly difficult and expensive. In one recent receivership the defendants emptied out the bank accounts by mailing out small dividend checks to defrauded investors — a technique which put instant money into the victims' hands, but which may effectively thwart the receiver's long term search for the lion's share of the assets. It is my suggestion that legislation be enacted which permits the CFTC to provide reasonable funding to allow receivers to do their job, rather than forcing us to look (with fright) at a potentially barren estate. Second, it is essential that receivers be permitted to review the agency's files immediately as to any and all information which could be helpful in allowing the receiver to do his job. Again, legislation which specifically provides that receivers are among those who are allowed entree to CFTC investigatory files would be helpful. Third, it is necessary that the regional offices and the states continue to work together in obtaining and aiding receivers. It would be helpful if the CFTC were to maintain a list of potential receivers in each region of the country, which list had been approved in advance by state authorities. This would also give a receiver with a problem in one part of the country, a list of lawyer - receivers to contact if necessary in another part of the country. Also, it might help the CFTC to delegate more decision-making authority on off-exchange fraud cases to regional offices. Further, it is important that legislation be enacted which either instructs courts to appoint a receiver at an early stage in the proceedings or which allows the CFTC to appoint a temporary receiver immediately on its own. After the receiver is appointed, however, there must be a continuing relationship between the receiver and state and federal authorities, in this case, Steve Leon, an assistant attorney general in New York. While his resources may be limited, his advice and support has been constantly appreciated. In the final analysis, then, it is my recommendation that the CFTC legislation, which currently ignores the best remedies for recovery of funds for defrauded investors, be amended to deal specifically with the appointment of equity receivers in off — exchange commodity fraud cases.

In the particular case of the CPI receivership, few assets are available in order to pursue the wrongdoers. It is small solace to the investors that Waggoner, Bederson, and others have been indicted, pled guilty and were sentenced to prison terms. Restitution should also be a goal. Perhaps if receiverships were to be funded through the CFTC rather than out of assets which are haphazardly captured by virtue of an injunction, a real effort to trace and recover monies could be undertaken in all cases. In this case, there are many potential avenues to pursue restitution, but the funding for them is still in doubt.

One interesting and perhaps unusual, aspect of this receivership lies in that fact that the oil scheme was international in scope. The Union Bank of Switzerland, with branches in Panama and New York City, handled large amount of money for Bartex, IPE and CPI. Informally, this bank has taken the position that, in dealing solely with American corporations and American citizens, it will cooperate with the receiver. Accounts involving foreign nationals are another matter and, to date, we have been unable to obtain information relative to CPI and its financial activities through the Union Bank of Switzerland. This is consistent with the attitude of international banks in general, as we are discovering. We find this particularly troubling in that we are dealing with the New York branches of these banks — which should give an American Court-appointed receiver more muscle.

In addition to pursuing the individual wrongdoers, we are also investigating the activities of various other entities whose conduct contributed to the victims' losses. One such entity is Dun & Bradstreet. The "report" on CPI from its Panamanian office helped create the original aura of legitimacy which allowed CPI to create its scheme. Likewise in at least one instance, Dun & Bradstreet mailing lists were used by selling companies to contact potential customers.

Another avenue that is being explored concerns various large newspapers which unquestioningly accepted advertisments for the sale of the crude oil contacts. While a few newspapers (such as the Chicago Tribune) apparently make some effort to screen this type of ad, most are willing to accommodate anyone who can pay for the space. This implicit participation in the solitication of investor's monies may create some responsibility toward those investors. Finally, we are reviewing the conduct of outside professionals, such as the attorneys and the bankers, whose actions aided this scheme.

As a receiver, I have been put into the position of explaining to people all over the country why their savings are lost and why we have such an uphill battle in trying to recover money for them. While these people suffer, participants in this off-exchange "commodities" fraud scheme may slip between the regulatory cracks —substantial funds may never be recovered. Specific positive legislative action, together with less regulatory red tape, could be of particular help to future victims.

PREPARED STATEMENT OF EUGENE FLEMING

I am an attorney in Boston. I have been appointed on the application of the Commodities Futures Trading Commission as Receiver in two cases involving fraud and theft by companies engaged ostensibly in the business of Commodities Futures trading. These companies are United States Investment Company, Ltd. and Norwell Tradewinds, Ltd. In each of these cases the companies were owned and apparently completely controlled by a single individual. In both cases, other individuals were involved in the operation of the company, primarily as sales or clerical personnel. In both cases it appears that the sales personnel were not involved in the fraud. The function of selling was sufficiently isolated from the handling of funds and trading on the commodities market that these sales personnel had no apparent way of knowing that anything was amiss.

While the sales personnel may not have been involved in the fraud, they were engaged in what might best be termed "boiler room" operations. They were armed with so-called "canned pitches", that is, a set speech to use on the potential customer, and had been instructed, and did in fact use, gross overstatements of the profit potential and safety of the investments. In short, there was almost a used-car salesman type approach to hooking in investors. While I am sure this approach contributed heavily to bringing the customers as quickly and easily as was done, it is not an integral part of the means by which the investors' money was taken.

There are, I am sure, many other common characteristics of these two frauds, but I think at this point it would be more useful to deal with them seperately.

United States Investments Company, Ltd. was organized in 1979 as a Massachusetts corporation by a man calling himself Herbert J. Kent. He has also been known variously as Jerald H. Kent, Jerry Kent, and Gerry Kent. Under the name Jerald H. Kent, he was convicted in the mid 1970's of obtaining over $300,000 in a stock fraud scheme while employed in a stock brokerage house in Boston. He served, I believe, 14 months in the Federal Prison System. A few years later, when he applied for registration with the CFTC in the fall of 1979, he was able to avoid his past by reversing his name of Jerald Herbert Kent to Herbert J. Kent and by using a different social security number than that under which he was convicted. This apparently was possible for at least three reasons.

First, the CFTC apparently has insufficient manpower to engage in very thorough investigation of applicants for registration.

Second, while the FBI was asked to screen the application, the switch of names and social security numbers avoided the computer check of outstanding criminal charges.

Third, there was no provision for fingerprinting of applicants which could have provided a much more thorough and accurate screening by the FBI.

Kent began his operation by capitalizing it with $5,000 of his own funds. He started with a small office in Wakefield, Massachusetts and within a few months moved into a larger office with 15-20 employees in Woburn. When the end came in April, 1981, USIC had over 35 employees and they had, since December, 1980 brought in over $3 million in investor funds of the total $7.2 million which was invested from July, 1979 through April 13, 1981.

Attached to this statement is a copy of a preliminary statement of the audit being performed on USIC. The sheets show what happened to the investors funds in terms of where, in general, the funds were disbursed. Briefly, $7 million was received; $800,000 was returned to customers to close accounts; approximately $550,000 "advanced" to Kent; $3 million paid to a Futures Commission Merchant (FCM) for commodities futures trading and commissions to the said merchant; approximately $950,000 for advertising, sales and promotion; $800,000 to salaries, wages, and commissions and the remainder to miscellaneous office and operational expenses.

The salesmen received a 10% commission on any amount of $10,000 or more brought in from any individual investor with a somewhat lesser commission for investment under $10,000, and a minimum initial investment of $7,500. Notes and memoranda from the sales office indicate that the common pitch to potential investors was that the Company consistently delivered 65% return on investment; that the customer's investment would be perfectly safe because of the expertise of their trader, Kent;

because they traded "both sides of the market" and because they provided what was called "margin insurance" on each account. A typical investment sequence would have the investor sending $10,000 and receiving periodically thereafter a statement of account status and activity, and on at least a monthly basis would reflect a debit of from $200 - $500 for "margin insurance". Trading activity always reflected transactions of one unit bought - one unit sold of any given commodity, thus fulfilling the salesman's description of playing both sides of the market. Nevertheless, of the $3 million paid to the FCM for trading and commissions, only $151,000 was recovered by the receivership and the books at USIC show receipt of $50,000 earlier. $3 million invested, $2.8 million lost. While this was going on, the statements sent to the investors showed each investor's equity to be hovering near the original investment. These statements were false in every respect.

It is at least ironic to note that while the sales personnel were assuring potential investors of a return of around 65% on their investment, USIC and Kent were skimming almost that percentage off the top of the investors' funds.

At the very heart of the fraud were the references provided to potential investors by USIC. These references were the large, reputable Commercial Bank holding the USIC accounts, the Better

Business Bureau, the CFTC itself. The bank, probably at Kent's request, assigned a Vice President, whose name and telephone number was given to investors, to answer inquiries. He told them that USIC had a middle six figure bank account with which there was no trouble. The Better Business Bureau reported that USIC was a reputable company against whom they had no complaints and which had been in existence for several years. The CFTC answered queries as to registration by saying "Yes, USIC is registered and there were no complaints against it". Thus, all of the references were positive, and were from impeccable sources.

Probably the final confirmation to investors that everything was right came when they received their cancelled investment checks, which contained the deposit stamp "Deposit Only to United States Investment Company, Ltd., Segregated Account" and an account number. Many investors with whom we have spoken thought that this account number was their own personal account, for they believed that their funds would be held and accounted for completely seperately.

Internally, only Kent was authorized to contact the FCM with whom USIC conducted trades, and only Kent drew up the information to be placed on the periodic statements sent to investors. Thus, there was no one who had access to that basic element of the fraud. Whether or not others in the company did or should have recognized that investors' funds were being used for operation of the company is simply a question for the criminal authorities.

The Futures Commission Merchant, with whom USIC dealt, had and traded two accounts, both in the name of USIC only. No one at USIC told the FCM that the funds of USIC were obtained from investors. The Commodities Exchange Act and the regulations do not impose any obligation on the FCM to satisfy itself as to the nature of the funds or to even inquire, and representatives of the FCM deny any such knowledge.

Customers were solicited through direct mail advertising, ads in the important financial and business periodicals and newspapers, and ads in selected alumni magazines. This latter was apparently particularly convincing to many.

Those are the basic and, I believe, salient facts which allowed Kent to perpetrate the fraud.

I would now like to take a very brief look at Norwell Tradewinds, Ltd.

Norwell Tradewinds was organized in mid-1980 by Edward Svagdis. It operated as a commodities trading adviser, and as a commodity pool operator. Several trading accounts were opened with an FCM in Dallas, Texas. As a pool operator, Norwell Tradewinds was authorized to accept funds from investors. It received funds in the amount of approximately $600,000 from something under 100 investors. It is not clear from the records currently available how much of those funds were misappropriated but at least $180,000 was lost by 18 investors. The Receivership has recovered about $7,500 so far. This is a simple case of misappropriation of funds entrusted to the Company, which funds the Company was legally authorized to accept. It was enjoined from further activities in the commodities trading area as was Edward Svagdis, the President, in July, 1981 by Consent Order of the United States District Court in Massachusetts.

My observations and experiences lead me to make certain recommendations:

First, there should be an industry [illegible]nd or insurance plan required by law to provide at least a minimum level of funding for a Receivership of a Commodities Futures company. As the matter now stands, if money is recovered by the Receiver, it opens the opportunity for more thorough work and substantially increases the possibility of collecting still further funds for the investors. Conversely, where the Receiver is not able to recover any funds, there is scant possibility of any substantial activity to the benefit of the wronged investors. A fund similar to that available in the securities market is perhaps the model to be used.

Second, Receivers should be authorized by law to invest any funds recovered in the receivership in Certificates of Deposit, Treasury Bills or Notes, or other reasonably secure investments so as not to leave the receivership funds fallow and shrinking because of receivership activity.

Third, a fingerprinting function should be required by law and funded for the CFTC to employ in all registration applicant investigations.

Fourth, all registrants with the CFTC should be required to disclose to the CFTC all bank accounts used by the registrant for the business, and to demonstrate that a notice has been given the bank setting out the source of funds, uses thereof and any trust or fiduciary arrangements applicable to each account.

Thank you for the opportunity to testify on this important matter. If I can provide any other assistance to this Committee, I will be honored to do so.

PREPARED STATEMENT OF HENRY ESCHWEGE

Mr. Chairman and Members of the Subcommittee:

We welcome your invitation to be here today to discuss our work relating to the Commodity Futures Trading Commission (CFTC). We have recently reviewed CFTC's major programs for ensuring the integrity of futures markets and protecting futures customers. I will direct my remarks to the programs of greatest interest to the subcommittee--the reparations program, registration of commodity professionals, and audit and financial surveillance.

REPARATIONS AND OTHER FORUMS FOR RESOLUTION OF CUSTOMER CLAIMS NEED TO BE MADE MORE EFFECTIVE

In 1974 the Congress amended the Commodity Exchange Act to establish a reparations program to serve as a forum to resolve the claims of commodity customers against industry professionals involving such matters as excessive or unauthorized trading, and fraud. The program was intended to provide an avenue for customer relief analogous to a small claims court, and midway in complexity between arbitration and court litigation, the traditional forums used in the futures industry. The program was to provide an expeditious, inexpensive, and easy-to-use process for handling cases.

Our work revealed that the reparations program is not meeting its objectives. Available statistics compiled by CFTC on the reparations program are not up-to-date or complete; however, the most recent data CFTC could supply us indicates that a reparations claim filed in 1978 took almost 3 years to complete the entire process. In fact, as of August 1981, only 53 individuals had actually received money as a result of reparations decisions. Our discussions with complainants and commodity attorneys indicated that complainants had considerable difficulty understanding important aspects of the program including how to enforce decisions and collect judgments. Reparations can be expensive, with commodity attorneys citing fees ranging from $1,000 to $10,000 for handling relatively small reparations claims.

Arbitration is potentially an effective and attractive alternative to reparations, especially for smaller claims. However, several factors have limited its use. Because arbitration panels include industry officials, both customers and commodity attorneys perceive these panels as having a pro-industry bias. Just as significant, many customers are not even aware that arbitration exists. Commodity exchange arbitration programs have additional drawbacks. For example, their jurisdiction is limited to disputes which concern their members' actions on their exchange. Further, the act places an unrealistically low $15,000 ceiling on the size of a claim which customers can compel exchange members to arbitrate.

The relatively high cost of court litigation makes it a useful alternative to reparations only for claims involving large amounts or difficult and complex issues. However, the Supreme Court now has under review the question of whether the Congress intended commodity customers to have a right of action under the act to sue CFTC registrants in Federal court.

To provide for more effective resolution of customer claims, CFTC needs to (1) improve reparations program management, (2) simplify its operation, and (3) support the development of arbitration at the exchanges and the National Futures Association as an effective alternative to reparations.

The Congress can assist in making available complaint resolution forums work better. To improve the potential of arbitration, the Congress should raise from $15,000 to $25,000 the dollar limit for claims which customers can compel exchange members to arbitrate or arbitrate through the National Futures Association. To resolve the issue of whether commodity customers can take their claims to Federal court, the Congress should clarify its intent regarding whether customers have a private right of action to adjudicate commodity related claims in this forum.

A MORE COMPREHENSIVE REGISTRATION PROGRAM IS NEEDED

The Commodity Exchange Act protects the trading public by requiring certain firms and individuals dealing in commodities to register with CFTC. To provide an effective registration program, CFTC needs to register industry professionals, screen them initially and on a continuing basis to remove unfit individuals, and assure a minimum level of competence. CFTC's registration program has weaknesses in each of these areas.

At present, registration is not required in an important area of the futures business, salespersons and supervisors of Commodity Trading Advisors and Commodity Pool Operators. Commodity Trading Advisors advise the public on trading strategies, while Commodity Pool Operators function in a manner analogous to mutual funds, investing the combined resources of many individual traders. Although the principals of these firms must register with CFTC, we believe that registration should also be required of the salespersons and supervisors who actually solicit business.

CFTC can take additional action to assure registrants' fitness. It can require Futures Commission Merchants to sponsor and review the registration application of persons associated with their firms. It can also fingerprint registrants and submit their fingerprints to the FBI for review. While CFTC has adopted rules to require sponsorship and fingerprinting, it has not adequately developed the automatic data processing support needed to administer the rules and has deferred their implementation until July 1, 1982.

Once a person is registered with CFTC, reregistration is relatively automatic. CFTC does not periodically check registrants against FBI or Securities and Exchange Commission files, or its own records to determine whether the registrant has committed acts which would make him no longer fit for registration.

Because futures trading requires substantial knowledge and is highly complicated, qualification standards and proficiency testing could also help CFTC protect futures customers. CFTC has proposed but has not finalized, rules which would require a proficiency examination as a condition of registration for persons associated with Futures Commission Merchants.

CFTC needs to take action in each of the areas I have highlighted. The newly created National Futures Association can address some of the weaknesses in the registration program since it is expected to assume many of CFTC's responsibilities. CFTC, however, needs to take a more active role in planning for the transfer of registration functions to the Association. Further, to overcome existing limitations on the Association's registration authority and allow a more complete transfer of responsibility, the Congress should amend the Act to authorize the Association to register all futures professionals; screen them through appropriate checks such as fingerprints; test them for their proficiency in futures; and allow professionals to appeal Association registration decisions.

CFTC CAN ALLOCATE AUDIT RESOURCES MORE EFFICIENTLY

CFTC has overall responsibility for ensuring that customer funds are properly safeguarded. Through enforcement of segregation of funds, recordkeeping, and minimum financial requirements, CFTC attempts to deter financial failures and detect improper financial practices which could result in the loss of customer funds. CFTC shares this responsibility with the commodity exchanges, which establish and enforce minimum financial requirements for their members. CFTC oversees the exchanges' implementation of their audit and financial surveillance programs.

CFTC has not efficiently used its audit resources for these purposes. During the past 2 years it has devoted considerable audit effort to firms which were exchange members, and therefore subject to exchange surveillance. At the same time, CFTC has devoted only a small amount of its effort to Commodity Pool Operators, a growing segment of the industry. In addition, CFTC has not taken all the steps it could--such as more frequent reviews and more specific program guidelines--to improve exchange audit and financial surveillance programs. CFTC has also not planned adequately for the transfer of audit functions to the National Futures Association.

CFTC needs to shift more of the audit responsibilities to the exchanges and the National Futures Association when it becomes operational. In doing so, however, CFTC needs to improve its own program for monitoring exchange audit and financial surveillance activities. This shifting of focus will allow CFTC to devote more audit resources to areas of the industry, for which it is primarily responsible.

SUPPLEMENTAL STATEMENT OF PHILIP MCBRIDE JOHNSON

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

TO SUPPLEMENT MY REMARKS THIS MORNING, I RESPECTFULLY REQUEST THAT THE ATTACHED EXHIBITS BE ADMITTED INTO THE RECORD OF THESE HEARINGS.[1] I HOPE THAT THESE EXHIBITS WILL HELP THE COMMITTEE TO SHARPEN ITS FOCUS ON THE COMMISSION'S EFFORTS TO DEVELOP A NATIONAL CAMPAIGN AGAINST OFF-EXCHANGE COMMODITY FRAUDS, AS WELL AS SOME OF THE PROBLEMS ENCOUNTERED IN THAT ENDEAVOR.

EXHIBITS A-1 THROUGH A-3 REFLECT CORRESPONDENCE RECEIVED BY THE COMMISSION FROM THE OFFICES OF THE UNITED STATES ATTORNEYS IN CHICAGO, NEW YORK CITY AND MINNEAPOLIS, COMMENDING THE COMMISSION FOR ITS ASSISTANCE IN SEVERAL CRIMINAL PROCEEDINGS BROUGHT AGAINST COMMODITY FRAUDS.

EXHIBIT B IS A LETTER FROM THE ATTORNEY GENERAL OF TEXAS COMMENDING THE COMMISSION FOR ITS ASSISTANCE IN A JOINT CFTC/TEXAS ACTION AGAINST A COMMODITY FIRM.

EXHIBIT C IS A LETTER FROM THE HONORABLE SHERMAN G. FINESILVER, UNITED STATES DISTRICT JUDGE FOR THE DISTRICT OF COLORADO, COMMENDING THE COMMISSION FOR ITS ASSISTANCE IN A RECEIVERSHIP PROCEEDING AGAINST A COMMODITY FIRM.

EXHIBIT D IS A LETTER SENT BY THE COMMISSION ON AUGUST 4, 1981 TO THE ATTORNEY GENERAL OF DELAWARE URGING THAT HIS OFFICE WORK WITH THE COMMISSION, AND INDEPENDENTLY, TO ATTACK OFF-EXCHANGE COMMODITY FRAUDS. IDENTICAL LETTERS WERE SENT TO THE ATTORNEY GENERAL OF EVERY OTHER STATE.

EXHIBIT E IS A COPY OF THE COMMISSION'S LETTER OF OCTOBER 28, 1981 TO THE PRESIDENT OF THE NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION (NASAA) REQUESTING THAT HE DISTRIBUTE TO ALL NASAA MEMBERS A COPY OF THE COMMISSION'S LETTER TO STATE ATTORNEYS GENERAL (EXHIBIT D).

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[1] The exhibits referred to were marked "Exhibits Nos. A-1 through M-2," for reference and remain in the files of the subcommittee.

Exhibit F is a copy of the Commission's "Spotters's Guide to Commodity Investment Frauds" which was completed and distributed in December.

Exhibit G-1 and G-2 are copies of the Commission's letters to the Attorney General of Delaware (identical letters sent to all State Attorneys General), and to the president of NASAA, transmitting the "Spotter's Guide" (Exhibit F).

Exhibit H is a draft syllabus for the spring seminar to be conducted by the Commission for the benefit of State law enforcement agencies and securities administrators.

Exhibit I is a list of the current members of the Commission's Advisory Committee on State Jurisdiction and Responsibilities, which includes the following State securities administrators:

Richard D. Latham, Texas (also NASAA first vice president)
Orestes J. Mihaly, New York (also NASAA member)
Michael Unger, Massachusetts (also NASAA director)
David Hart Wunder, Illinois (also NASAA president)

Exhibits J-1 through J-5 are copies of complaints in cases that have been filed jointly (as co-plaintiffs) by the Commission and State law enforcement agencies:

CFTC and State of New York v. Commercial Petrolera Internacional, S.A., et. al, Civ. No. 80-2082 (S.D. N.Y. 1980)

CFTC and State of Maryland v. Annapolis Funding Company, et. al, Civ. No. 80-1723 (D. Md. 1980)

CFTC and State of Georgia v. Sterling Capital Company, et. al, Civ. No. 80-835 (N.D. Ga. 1980)

CFTC and State of Texas v. International Bullion Clearing Corporation, et. al, Civ. No. 81-12 (W.D. Tex. 1981)

CFTC and Commonwealth of Massachusetts v. Norwell Trade Winds, Ltd., et. al, Civ. No. 81-1749 (D. Mass. 1981)

Exhibits K-1 and K-2 are a copy of a letter dated February 2, 1982 from the Commission to Michael Unger, Massachusetts securities administrator (and a member of the Commission's Advisory Committee as well as a witness at these hearings), inviting participation by his office in a recent commodity case, and Mr. Unger's letter of February 4, 1982 declining to do so.

Exhibit L is a copy of the Commission's letter of October 15, 1981 to the Illinois securities administrator's office (headed by David Hart Wunder, a member of the Commission's Advisory Committee and a witness at these hearings), inviting that agency to join in an action brought by the Commission. The invitation was declined.

Exhibits M-1 and M-2 are copies of a memorandum from the past president of NASAA (a witness at these hearings), Thomas L. [illegible], dated August 26, 1981 to all NASAA members urging a campaign to generate complaints and criticisms against the Commission, for Congressional consumption, and a letter (no reply) from the Commission's chairman to Mr. Krebs urging that the members of NASAA join instead with the Commission in its effort to crack down on commodity fraud.

PREPARED STATEMENT OF ROBERT L. ISAACSON

MR. CHAIRMAN, SENATORS, LADIES AND GENTLEMEN:

GOOD MORNING. MY NAME IS ROBERT L. ISAACSON. I AM PRESIDENT OF FUTURES INVESTMENT CONSULTANTS, INC., A REGISTERED COMMODITY POOL OPERATOR AND COMMODITY TRADING ADVISOR. I AM APPEARING THIS MORNING IN MY CAPACITY AS A DIRECTOR OF THE NATIONAL ASSOCIATION OF FUTURES TRADING ADVISORS (NAFTA). I WELCOME THE OPPORTUNITY TO PRESENT THIS STATEMENT TO THE SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS IN CONNECTION WITH ITS PROBE OF ILLEGAL COMMODITY INVESTMENT SCHEMES. SPECIFICALLY, OUR COMMENTS RELATE TO THE SUBCOMMITTEE'S INVESTIGATION CENTERED ON "OFF-EXCHANGE" COMMODITY TRANSACTIONS AND COMMODITY POOL OPERATORS AS WELL AS THE APPROPRIATE ROLE THAT STATE SECURITITS ADMINISTRATORS SHOULD PLAY IN POLICING ANY FRAUD OCCURRING IN THIS AREA.

AS THE SUBCOMMITTEE MAY BE AWARE, NAFTA'S MEMBERSHIP IS COMPRISED OF MORE THAN 120 OF THE INDUSTRY'S LEADING COMMODITY TRADING ADVISORS (COMMONLY CALLED CTAs) AND COMMODITY POOL OPERATORS (COMMONLY CALLED CPOs) WITH OVER $700,000,000 OF CLIENT ASSETS UNDER MANAGEMENT. NAFTA IS A NON-PROFIT PROFESSIONAL ASSOCIATION WHICH SEEKS RESPONSIBLE WAYS TO REPRESENT THE INTERESTS OF CTAs AND CPOs TO THE PUBLIC, THE COMMODITY INDUSTRY AND FEDERAL AND STATE REGULATORY AGENCIES. NAFTA FEELS THAT ITS MEMBERS REPRESENT A FAIR CROSS SECTION OF THE CTAs AND THE CPOs CURRENTLY REGISTERED WITH THE COMMODITY FUTURES TRADING COMMISSION (CFTC). CONSEQUENTLY, NAFTA BELIEVES THAT IT IS UNIQUELY QUALIFIED TO COMMENT ON THIS SEGMENT OF THE FUTURES INDUSTRY AND THE INVESTING PUBLIC WHOSE CAPITAL IS MANAGED BY CTAs AND CPOs.

IN ITS RECENT RELEASE ANNOUNCING THESE HEARINGS, CHAIRMAN WILLIAM D. ROTH, JR. EXPRESSED SIGNIFICANT CONCERN THAT AMERICAN CONSUMERS HAD LOST HUNDREDS OF MILLIONS OF DOLLARS BY INVESTING IN FRAUDULENT TRANSACTIONS INVOLVING SUCH COMMODITIES AS GOLD, SILVER, OIL, GAS AND STRATEGIC METALS. AFTER OBSERVING THAT MANY INVESTORS WERE "BEING CONNED INTO INVESTING BY BOILER ROOM TELEPHONE SALES OPERATORS AND SLICK PROMOTIONAL MATERIALS," CHAIRMAN ROTH CONCLUDED THAT "NO INVESTOR IS SAFE" FROM SUCH SHADY OPERATORS.

NAFTA SHARES THE CHAIRMAN'S CONCERNS FOR ANY SUCH COMMODITY SCAMS. WE DECRY ANY SITUATION IN WHICH MEMBERS OF THE PUBLIC ARE DEFRAUDED OF THEIR MONIES. MOREOVER, NAFTA SUPPORTS WELL DESIGNED DISCLOSURE STANDARDS AND DILIGENT ENFORCEMENT OF ANTI-FRAUD STANDARDS BY STATE AS WELL AS FEDERAL AUTHORITIES. IN FACT, IN ITS 1980 COMPREHENSIVE COMMENT LETTER RELATING TO THAT AGENCY'S THEN-PROPOSED CTA/CPO REGULATIONS, NAFTA URGED THE CFTC TO WORK WITH THE STATES TO TAKE A GREATER ENFORCEMENT ROLE IN THIS AREA. NAFTA BELIEVES THAT THE STATES' ENFORCEMENT EXPERIENCE AND EFFORTS PROVIDE A VALUABLE, SUPPLEMENTARY ROLE TO THE CFTC'S ANTI-FRAUD ENFORCEMENT EFFORTS.

IT SHOULD BE EMPHASIZED, HOWEVER, THAT MOST OF THE SCAMS THIS SUBCOMMITTEE WILL BE ADDRESSING ARE NOT COMMODITY FUTURES CONTRACTS — THE PRIMARY INSTRUMENTS SUBJECT TO THE JURISDICTION OF THE CFTC. HENCE, ANY INVESTMENT SCHEME WHICH RELATES TO GOLD, SILVER, OIL, GAS, STRATEGIC METALS, FOR EXAMPLE, IS NOT NECESSARILY SUBJECT TO CFTC REGULATION. NAFTA DOES NOT DISPUTE THAT VARIOUS RIP-OFFS WHICH NOMINALLY HAVE THE COLOR OF COMMODITIES DO OCCUR. HOWEVER, MANY, IF NOT MOST, OF THE INVESTMENT SCAMS WHICH WILL BE DESCRIBED BEFORE THE SUBCOMMITTEE COULD, TO USE CFTC CHAIRMAN PHILIP JOHNSON'S PHRASELOGY, BE CHARACTERIZED AS "FRAUDS MASQUERADING AS LEGITIMATE COMMODITY INVESTMENTS." THEY SHOULD BE SO PROSECUTED.

LET ME OFFER SPECIFIC EXAMPLES OF WHAT I MEAN. EACH OF THE FOLLOWING OFF-EXCHANGE SITUATIONS NOMINALLY INVOLVES A COMMODITY BUT IS NOT SUBJECT TO CFTC JURISDICTION: COAL TAX-SHELTERS, RABBIT OR CATTLE BREEDING, JOJOBA BEAN FARMING, INVESTMENT DIAMONDS, NUMISMATIC COINS, OIL AND GAS EXPLORATION, SILVER OR EMERALD MINES. THUS, IT IS AN UNFAIR CRITICISM TO ARGUE THAT THE CFTC HASN'T BEEN DOING ITS JOB. EACH OF THESE ENUMERATED INVESTMENT SCHEMES HAVE HAD THEIR SHARE OF FRAUDS. ALTERNATIVELY, THEY CAN BE PROSECUTED AS A FRAUD OR, IN APPROPRIATE CIRCUMSTANCES IF AN INVESTMENT CONTRACT IS INVOLVED, AS A SECURITY VIOLATION.

ACCORDINGLY, WE WOULD URGE THE SUBCOMMITTEE IN ITS EXAMINATION TO DISCRIMINATE BETWEEN LEGITIMATE COMMODITIES ACTIVITIES SUBJECT TO THE EFFECTIVE JURISDICTION OF THE CFTC AND OFF-EXCHANGE ACTIVITIES WHICH ARE NOT SUBJECT TO ITS REGULATORY JURISDICTION. THIS WOULD INCLUDE SUCH BROAD AREAS AS CASH COMMODITIES, SO-CALLED "FORWARD CONTRACTS," AND A WHOLE PANOPLY OF INVESTMENT SITUATIONS THAT CANNOT BE EFFECTIVELY REGULATED BY THE CFTC. NAFTA RECOGNIZES THAT FRAUDS IN COMMODITIES EXIST. HOWEVER, SUCH OBSERVATION REQUIRES A MORE DETAILED ANALYSIS:

(1) ARE COMMODITIES FUTURES CONTRACTS SUBJECT TO CFTC JURISDICTION INVOLVED?

(2) ARE COMMODITIES THAT ARE NOT SUBJECT TO CFTC JURISDICTION INVOLVED?

(3) DO THE SITUATIONS INSTEAD ONLY PURPORT TO INVOLVE COMMODITIES BUT REALLY CONSTITUTE OUT-AND-OUT FRAUD SUBJECT TO THE TRADITIONAL ENFORCEMENT CAPABILITIES OF THE STATES?

NAFTA AND ITS MEMBERS FEEL VERY STRONGLY THAT ANY FRAUDULENT ACTIVITY MUST BE ERADICATED. NOT ONLY DO FRAUDS BY THESE "FRINGE ELEMENTS" HURT THE INVESTOR BUT IT ALSO HARMS THE LEGITIMATE PROFESSIONAL PROVIDING A REASONABLE INVESTMENT ALTERNATIVE TO THE PUBLIC. HOWEVER, IT IS CLEAR THAT TO THE EXTENT THAT PERSONS ARE NOT REGISTERED WITH THE CFTC OR ENGAGE IN ACTIVITIES NOT SUBJECT TO ITS JURISDICTION, IT IS NOT WITHIN THE CAPABILITY OF THE CFTC TO ENFORCE EVERY FRAUD FOISTED UPON THE PUBLIC.

MOREOVER, WHERE ACTIVITIES ARE SUBJECT TO THE CFTC's GRANT OF EXCLUSIVE JURISDICTION, THE CFTC AND/OR THE STATES HAVE JOINT AUTHORITY TO AGGRESSIVELY PROSECUTE IN FEDERAL COURTS IN THE SITUS OF THE FRAUD. IT HAS BEEN IN THAT SPIRIT THAT GREATER ENFORCEMENT COOPERATION BETWEEN THE STATES HAS BEEN URGED BY THE CFTC.

NAFTA BELIEVES THAT THE STATES AND THE CFTC SHOULD DECLARE AN "OPEN SEASON" ON ALL FRAUDS, WITH THE STATES CONCENTRATING THEIR EFFORTS ON OFF-EXCHANGE SITUATIONS. NAFTA FEELS THAT THE STATES ALREADY HAVE THE AUTHORITY TO INVESTIGATE AND, WHERE APPROPRIATE, TO PROSECUTE FRAUD. WE, OF COURSE, SUPPORT ANY EFFORT TO MAKE SUCH AUTHORITY EXPRESSLY RESERVED TO THE STATES. IN THAT SPIRIT, THE CFTC HAS PROPOSED LEGISLATION WHICH WILL ADDRESS THESE VERY CONCERNS:

(1) PROPOSED §8(e) OF THE COMMODITY EXCHANGE ACT WOULD SPECIFICALLY PERMIT THE CFTC TO SHARE OTHERWISE CONFIDENTIAL INFORMATION WITH THE STATES; AND

(2) PROPOSED §12(e) WOULD EXPRESSLY PROVIDE THAT ANY STATE OR FEDERAL STATUTES RELATING TO A COMMODITY NOT TRADED ON A CONTRACT MARKET ARE NOT PREEMPTED.

NAFTA BELIEVES THAT ADOPTION OF SUCH CFTC LEGISLATIVE PROPOSALS DURING ITS REAUTHORIZATION CONSIDERATION WILL PROVIDE AN EFFECTIVE FRAMEWORK RESPONSIVE TO THESE CONCERNS.

AS THE SUBCOMMITTEE IS UNDOUBTEDLY AWARE, THE BACKGROUND OF THIS QUESTION IS BY NO MEANS A CLEAN STATE. CONGRESS EXPRESSLY GRANTED TO THE CFTC "EXCLUSIVE JURISDICTION" IN CERTAIN AREAS IN 1974 AND STRENGTHENED THAT AUTHORITY IN THE 1978 AMENDMENTS RESULTING IN REAUTHORIZATION OF THE CFTC. UNFORTUNATELY, THE CONNOTATION OF EXCLUSIVE JURISDICTION IS FAR GREATER THAN ITS REALITY! FOR THE RECORD AND FOR THE BENEFIT OF THE SUBCOMMITTEE MEMBERS, I HAVE ATTACHED AN APPENDIX STYLED "LEGISLATIVE HISTORY SUMMARY" OUTLINING THE CURRENT LEGAL ENVIRONMENT AND RELEVANT PASSAGES RELATIVE TO CREATION OF, AND EXCLUSIVE JURISDICTION IN, THE CFTC. HOWEVER, THAT EXCLUSIVE JURISDICTION SHOULD NOT BE MISUNDERSTOOD TO MEAN THAT THE STATES HAVE NO AUTHORITY OR THAT THE CFTC's JURISDICTION EXTENDS TO EVERYTHING DESCRIBED AS A COMMODITY. THAT COULD NOT BE FURTHER FROM THE TRUTH. STATES ARE SPECIFICALLY EMPOWERED TO ENFORCE THE COMMODITY EXCHANGE ACT WHERE VIOLATIONS HAVE OCCURRED.

IT CAN THUS BE SEEN THAT THERE IS AN ENORMOUS WINDOW FOR COMMODITY SCAMS WHICH DO NOT FALL WITHIN THE JURISDICTION OF THE CFTC. SIMILARLY, UNLESS AN INVESTMENT CONTRACT THEORY IS PURSUED, THE SEC ALSO IS WITHOUT JURISDICTION. FOR THESE REASONS, NAFTA STRONGLY SUPPORTS STATE ENFORCEMENT OF ANY FRAUDULENT ACTIVITIES WHETHER OR NOT THE CFTC HAS JURISDICTION. IN THOSE COMMODITIES SUBJECT TO CFTC EXCLUSIVE JURISDICTION, NAFTA'S SOLE CONCERN WOULD BE ANY EFFORT BY THE STATES TO CREATE 50 ADDITIONAL "RULE BOOKS" WHICH WOULD NOT BE UNIFORMLY ADMINISTERED BY THE CFTC IN ITS ROLE AS EXPERT AGENCY IN THE AREAS OVER WHICH IT DOES HAVE AUTHORITY.

LET ME GIVE YOU AN EXAMPLE OF CONFLICTING, OVERLAPPING REGULATION. PRIOR TO THE GRANT BY CONGRESS OF EXCLUSIVE JURISDICTION TO THE CFTC, THERE WAS CONSIDERABLE DIFFERENCE OF OPINION AS TO WHETHER DISCRETIONARY COMMODITY ACCOUNTS IN FUTURES CONTRACTS ARE "INVESTMENT CONTRACTS" AND, THEREFORE, SECURITIES REQUIRING REGISTRATION: 23 JURISDICTIONS SAID NO; 16 SAID YES; AND 13 JURISDICTIONS TOOK NO POSITION. (EVEN THOSE JURISDICTIONS IN WHICH DISCRETIONARY ACCOUNTS WERE DEEMED TO BE SECURITIES, ADMINISTRATIVE TREATMENT WAS ALL OVER THE LOT —NOT A VERY ATTRACTIVE ALTERNATIVE FOR AN INDUSTRY WHICH IS INCREASINGLY INTERNATIONAL IN SCOPE). IT IS CLEAR THAT CONGRESS' MANDATE OF EXCLUSIVE JURISDICTION RECOGNIZED THE NEED FOR A UNIFORM, NATIONAL, COMPREHENSIVE REGULATORY SCHEME OVER COMMODITY FUTURES CONTRACTS, THE RESPONSIBILITY FOR WHICH SHOULD RESIDE IN THE CFTC. NAFTA KNOWS OF NO REASON WHY THAT RESPONSIBILITY SHOULD CHANGE.

FOR EXAMPLE, COMMODITY POOLS ARE A UNIQUE INVESTMENT VEHICLE IN THAT THEY OFFER TO SMALLER PUBLIC INVESTORS PROFESSIONAL TRADING MANAGEMENT, LIMITED LIABILITY, INVESTMENT DIVERSIFICATION, ADMINISTRATIVE CONVENIENCE, AND REDUCED BROKERAGE COMMISSIONS. THE POOL INDUSTRY IS ALREADY SUBJECT TO A UNIFORM, COMPREHENSIVE, REGULATORY SCHEME. IT IS FOR THAT REASON THAT NAFTA HAS SPOKEN VERY FORCEFULLY IN FAVOR OF ITS CONTINUED EXCLUSIVE JURISDICTION BY THE CFTC. HENCE, EXCEPT TO ENFORCE ANY FRAUDS, STATE REGULATION OF COMMODITY POOLS IS NOT NEEDED AND SHOULD CONTINUE TO BE PREEMPTED.

TO THE EXTENT THAT THE CFTC DOES NOT HAVE JURISDICTION OVER CASH COMMODITIES OR OTHER SITUATIONS WHICH FALL OUTSIDE OF THE CFTC'S JURISDICTION, THEN CLEARLY THE STATES HAVE THE PREROGATIVE TO PURSUE THESE MATTERS. NAFTA RECOGNIZES THAT THE KEY TO THE PREVENTION, INVESTIGATION AND PROSECUTION OF FRAUD IS A SIGNIFICANT ENFORCEMENT ACTIVITY. NAFTA WOULD NOT OPPOSE ANY EFFORT TO WEED OUT THOSE WHO CLAIM TO BE MEMBERS OF THE INDUSTRY AND DEFRAUD THE PUBLIC OR THOSE LIMITED NUMBERS IN THE INDUSTRY WHO ABUSE THAT TRUST.

CHAIRMAN ROTH IS ATTRIBUTED TO HAVE SAID THAT THE CFTC, DESPITE ITS BEST EFFORTS, SIMPLY DOES NOT TO HAVE THE RESOURCES TO COPE WITH THE PROBLEM. WE ENTIRELY AGREE WITH THAT ASSESSMENT. TO RECAPITULATE THE OBSERVATIONS ADDRESSED IN THIS TESTIMONY, IT SHOULD BE RECOGNIZED:

(1) THE CFTC DOES NOT HAVE JURISDICTION OVER EVERY TYPE OF COMMODITY, BUT RATHER IT HAS EXCLUSIVE JURISDICTION ONLY OVER A LIMITED PORTION OF THE COMMODITY INDUSTRY — SPECIFICALLY COMMODITY FUTURES CONTRACTS, COMMODITY OPTIONS, LEVERAGE CONTRACTS AND CERTAIN COMMODITY OPTION DEALERS.

(2) THE CFTC'S EFFORTS, ON BALANCE, HAVE BEEN QUITE EFFECTIVE IN DEALING WITH THOSE PORTIONS OF THE INDUSTRY (SUCH AS COMMODITY POOLS, INDIVIDUALLY MANAGED ACCOUNTS, FUTURES COMMISSION MERCHANTS, AND THE EXCHANGES) DIRECTLY SUBJECT TO ITS DELEGATED AUTHORITY.

(3) THE STATES ARE NOT PREVENTED FROM TAKING ENFORCEMENT ACTION UNDER THE COMMODITY EXCHANGE ACT OR UNDER THEIR OWN GENERAL CRIMINAL STATUTES. ACCORDINGLY, IT IS NOT ACCURATE TO STATE (AS THE SUBCOMMITTEE'S RELEASE ANNOUNCING THIS HEARING DID) THAT "UNDER THE COMMODITY EXCHANGE ACT AS AMENDED IN 1978, STATE REGULATION OF VIRTUALLY ALL ASPECTS OF COMMODITY TRADING IS PREEMPTED BY THE FEDERAL GOVERNMENT."

(4) THE INDUSTRY SHARES THE CONCERNS EXPRESSED. DURING ITS RECENT PHENOMENAL GROWTH, THERE HAS BEEN EVOLVING BY THE INDUSTRY ITSELF EFFORTS TO DEVELOP CONTROLS AND ADMINISTER RULES DESIGNED TO PROTECT THE INVESTING PUBLIC. ITS RESPONSIBLE MEMBERS ARE NOW IN THE PROCESS OF ORGANIZING A SELF REGULATORY BODY STYLED THE NATIONAL FUTURES ASSOCIATION (THE NFA). ENCOURAGED BY THE CFTC AND SUPPORTED BY A SIGNIFICANT PORTION OF THE INDUSTRY, THE ROLE AND FUNCTION OF THE NFA WILL PARALLEL THAT OF THE NATIONAL ASSOCIATION OF SECURITIES DEALERS IN THE SECURITIES INDUSTRY.

NAFTA FEELS THAT THE EXPERIENCE, MATURITY, EXPERTISE AND DESIRES ARE NOW AVAILABLE TO MAKE A TITLE III SELF-REGULATORY ORGANIZATION EFFECTIVE AND BETTER SERVE THE INTERESTS OF THE INVESTING PUBLIC. NAFTA CONCURS WITH THE VIEW THAT CREATION OF THE NFA WILL PERMIT MORE EFFECTIVE POLICING BY THE FUTURES INDUSTRY ITSELF OF THOSE SEGMENTS OPERATING OUTSIDE THE SYSTEM OF EXCHANGE STANDARDS AND SURVEILLANCE.

(5) IN THE RELEASE ANNOUNCING THIS HEARING, THE STATEMENT IS MADE THAT "LEGISLATIVE ACTION MAY BE NEEDED TO INSURE THAT THE AVERAGE PENSIONER WILL BE ABLE TO PROTECT HIS FINANCES BY LEGITIMATELY INVESTING THEM." NAFTA CONCURS BUT, AS OUTLINED HEREIN, FEELS THAT THE CFTC LEGISLATIVE PROPOSALS CLEARLY DELINEATING THE ROLE OF THE STATES WITH REGARD TO OFF-EXCHANGE TRANSACTIONS IS RESPONSIVE TO THAT OBJECTIVE.

IN CONCLUSION, I WOULD LIKE TO LEAVE WITH YOU A GRIM EXAMPLE OF THE CONCERNS THAT NAFTA HAS WITH REGARD TO THE MANAGED ACCOUNT SEGMENT OF THE COMMODITIES INDUSTRY. FREQUENTLY, THOSE SEEKING TO LEGISLATE OR REGULATE THE INDUSTRY DO NOT HAVE COMMODITIES EXPERTISE. FOR EXAMPLE, ALTHOUGH NO CASES OF ABUSE WERE CITED, THE NORTH AMERICAN SECURITIES ADMINISTRATOR'S ASSOCIATION, NOTWITHSTANDING THE GRANT OF EXCLUSIVE JURISDICTION BY CONGRESS TO THE CFTC, HAS PROPOSED A NUMBER OF COMMODITY POOL "GUIDELINES" WHOSE REGULATIONS HAVE GROWN OUT OF COMPLETELY ERRONEOUS ANALOGIES TO SUCH DISPARATE

AREAS AS REAL ESTATE, OIL AND GAS, INVESTMENT COMPANY, AND INVESTMENT ADVISER AND CHURCH BOND SECURITIES REGULATIONS. NAFTA WOULD URGE THE SUBCOMMITTEE TO CLOSELY EXAMINE THE JURISDICTION CURRENTLY RESIDING IN THE CFTC TO UNDERSTAND THAT MANY OF THE INVESTMENT SCAMS THAT ARE ALLUDED TO HAVE RESULTED PRINCIPALLY BECAUSE OF ONE OF TRHE FOLLOWING REASONS:

(1) THE CFTC DID NOT HAVE JURISDICTION;

(2) THE PERSON WHO IS DEFRAUDING THE PUBLIC DID NOT COMPLY WITH THE COMPREHENSIVE SCHEME OF APPROPRIATE REGULATION; OR

(3) THE STATES DID NOT TAKE ACTION UNDER THEIR EXISTING AUTHORITY TO INVOKE THE COMMODITY EXCHANGE ACT, STATE SECURITIES LAWS OR THEIR OWN EXISTING CRIMINAL STATUTES.

IN CONCLUDING MY FORMAL REMARKS, I WOULD LIKE TO EMPHASIZE THAT NAFTA SUPPORTS WELL-CONCEIVED DISCLOSURE STANDARDS AND AGGRESSIVE ENFORCEMENT OF ALL FRAUDS. NAFTA BELIEVES THAT THE CFTC HAS ACQUITTED ITSELF EFFECTIVELY IN VERY DIFFICULT TIMES AND CIRCUMSTANCES IN THE AREAS OVER WHICH IT HAS AUTHORITY AND SHOULD BE REAUTHORIZED. SO LONG AS THE STATES ARE NOT IN THE BUSINESS OF REGULATING THE INDUSTRY NAFTA ALSO SUPPORTS THE SIGNIFICANT ENFORCEMENT ACTIVITIES OF THE STATES IN COORDINATION WITH AND SUPPLEMENTAL TO THE ACTIVITIES OF THE CFTC UNDER THE CEA. IN ADDITION, NAFTA SUPPORTS CURRENT EFFORTS INITIATED BY THE CFTC DELINEATING THE PERMISSIBLE ROLE THE STATES MAY PURSUE IN ENFORCING OFF-EXCHANGE COMMODITY TRANSACTIONS. FINALLY, NAFTA TRUSTS THAT THE SUBCOMMITTEE WILL BE DISCRIMINATING IN ITS ASSESSMENTS OF THE ROLE OF THE LEGITIMATE COMMODITIES INDUSTRY AND SCAMS WHICH PURPORT TO BE COMMODITIES INVESTMENTS BUT ARE PLAIN-AND-SIMPLE FRAUDS UPON THE PUBLIC. WHETHER SUBJECT TO THE CFTC, THE SEC AND/OR THE STATES, EVERY REASONABLE EFFORT TO PROSECUTE SUCH FRAUDS SHOULD BE PURSUED.

I WOULD BE PLEASED TO RESPOND TO ANY QUESTIONS YOU MAY HAVE. THANK YOU VERY MUCH.

PREPARED STATEMENT OF ROBERT K. WILMOUTH

Mr. Chairman and members of the Committee, I am pleased to respond to your request to present a written statement concerning high pressure sales of non-exchange commodity instruments. It is my understanding that these instruments purport to offer precious metals, strategic metals, crude oil or gasoline, foreign currencies, or coal and that the public has been fleeced of millions of dollars. Based upon your Committee's disclosures, I understand that these instruments are being offered and sold through what have become known as "boiler rooms" by the use of high pressure sales tactics. These firms are not registered with the Commodity Futures Trading Commission and are not members of any of the commodity futures exchanges or any other commodity industry organization.

As I previously informed the Committee, the Board of Trade has no information that any of its members have engaged in any of the activities which are the subject of these hearings. Obviously, if any such conduct comes to the attention of the Board of Trade, it would be immediately and thoroughly investigated.

It is not surprising that the commodity exchange community supports every effort that can be mustered to eliminate firms that are engaged in these alleged fraudulent activities. The activities of these fringe elements unfortunately cast a dark shadow over the reputation of legitimate industry participants. When the uninitiated public reads in the press about a precious metals scam or a fraudulent coal "exchange," they do not fully realize that those activities are not part of the legitimate commodities industry.

The commodity futures exchanges provide essential economic services to the national economy by permitting not only agribusinesses, but all financial segments of the economy to reduce their risks in this extremely volatile economy. Directly or indirectly, businesses must include a significant risk factor in the pricing of their products; but if they are able to reduce or stabilize those risks, the provision for risk in their pricing can be reduced, to the benefit of the consumers at large.

However, the so-called commodity contracts on coal, metals, and exotic metals do not fulfill these vital functions. They are not hedging or price discovery mechanisms, which are the hallmarks of the commodity futures exchange markets. From my understanding of these operations, they do not provide any significant benefit to our economy.

Indeed, most of these high pressure firms try to escape governmental regulation by the CFTC by casting their "contracts" in terms of what they call "deferred delivery contracts" in an attempt to avoid the coverage of the Commodity Exchange Act and the requirement that these contracts meet the "economic purpose" test for "futures contracts traded on exchanges." In addition, they choose "commodities," such as strategic metals, gasoline and coal, that may not be covered by the Commodity Exchange Act. At the moment it is not clear whether such "commodities" are within the definition of commodities in Section 2(a)(1) of the Commodity Exchange Act or within the commodities covered by the CFTC's authority to regulate commodity options under Section 4c of that Act. In short, these firms purposely retail commodity instruments which they contend are not subject to governmental regulation and which are not traded on exchanges.

The Commodity Futures Trading Commission has recently recommended legislation which is contained in Section 19 of S. 2109 that would subject these activities to prosecution under any applicable federal or state statute. The Board of Trade supports the concept of this proposed amendment, which is pending before the Senate Agriculture, Nutrition, and Forestry Committee. We have not had an opportunity to fully analyze that provision but will later submit our views to that Committee.

I believe that the states' enforcement weapons should be directed at these fraudulent activities which this Committee has brought to light and is highlighting in these hearings. However, any change in the Commodity Exchange Act to permit the states to require registration of legitimate industry participants in the commodity futures markets would not curtail these fraudulent activities but would only place additional and absolutely unnecessary burdens on legitimate industry participants. Just as most of the firms that are "pedaling" these off-exchange instruments have not registered with the Commodity Futures Trading Commission, they would not register with the states. It is my view that these activities are controllable only through vigorous enforcement action by the federal and state governments.

In order to give this Committee a better idea of the extensive regulation to which members of the commodity exchange community are subject as compared with these fringe elements, let me briefly outline the industry's self-regulatory efforts to protect the integrity of the commodity exchange marketplace.

Self-regulation is, of course, a key element in the regulatory scheme of the Commodity Exchange Act. In this regard, however, the Act reflects and is intended to impose mechanisms which had developed long before the advent of federal regulation. The Board of Trade, for example, was incorporated in 1859 as a "body politic and corporate," and among its objects were "to inculcate principles of justice and equity in trade," and "to facilitate the speedy adjustment of commercial disputes."

By 1875, the Board of Trade had a highly organized and sophisticated self-regulatory program, complete with rules governing business conduct as well as commercial standards and machinery for their enforcement.

Considering the fact that most other American industries have never evolved a formal self-regulatory system, what prompted the Chicago Board of Trade and other exchanges to do so? Those who could provide a reliable answer to that question have long since departed this world. Our best guess is that at least two factors helped to bring about a self-regulatory structure among the exchanges.

First, these were centralized markets where most participants operated in close proximity. This made it easier to organize a common code of behavior and also to enforce it. Second, these were markets extremely sensitive to the ebb and flow of public confidence. It was only "good business" to weed out those members of the industry whose activities threatened public confidence in the markets.

The users of futures markets are protected in a unique and comprehensive way by exchange customer protection rules, the customer protection provisions of the Commodity Exchange Act and CFTC Regulations, and exchange and CFTC market regulation powers, as well as exchange margin controls. This integrated regulatory system, which in major respects predates federal securities regulation by a decade, serves as a model for other regulatory systems.

Over the last century, the Board of Trade has developed a detailed system of regulation, codified in a rulebook of several hundred pages. Now operating under the pervasive oversight jurisdiction of the CFTC, the Board of Trade's regulatory system assures, far more efficiently and effectively than any direct federal system, that futures trading on the Board of Trade is conducted in a fair and competitive manner and in the public interest.

For example, the Board of Trade maintains (at no taxpayer cost) a comprehensive system for the protection of customers of Board of Trade members. This system, which is in addition to the Board's regulation of trading on the exchange floor, consists principally of strict customer protection rules and an extensive program for enforcing those rules.*/

As you may be aware, the Commodity Futures Trading Commission has recently designated the National Futures Association as a self-regulatory organization authorized under Title III of the Commodity Futures Trading Commission Act of 1974. The NFA's basic objectives are twofold and are incorporated in NFA rules already approved by the Commodity Futures Trading Commission and for which implementing programs are being developed:

1. More effective policing by the futures industry itself of those segments operating outside the system of exchange standards and surveillance.

2. Better cost control over regulatory expenses by eliminating duplication, overlap, and conflict between existing governmental and self-regulatory programs, and by facilitating a reduction in the cost of federal regulation -- for the benefit of taxpayers in general and market users in particular.

Although a primary objective of the NFA is to regulate those CFTC registrants which are not members of the exchanges, it is unlikely that the association (even when it becomes fully operational) can have any significant impact on the activities which this Committee is bringing to light. Again, it must be understood that most of the firms that are pedaling these instruments seek to avoid registration with the CFTC and thus would not be members of the NFA and subject to its regulations.

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*/ A summary of the Board of Trade's rules and regulations as well as the actual rules and regulations are contained in Appendix A.

Under the NFA's Articles and Bylaws as approved by the CFTC, it will have the responsibility for regulating the sales practices with regard to futures contracts traded on commodity exchanges (off-exchange futures contracts are prohibited by the Commodity Exchange Act), options on futures options. To the extent a leverage contract dealer is registered with the CFTC as a commodity trading advisor (and many are), their advisory activities also would be subject to NFA regulation.

Thus, it is apparent that the legitimate industry participants are taking the lead in regulating and enhancing the conduct of virtually all those who wish to transact legitimate business and register with the Commodity Futures Trading Commission. The Board of Trade believes that the NFA when fully operational will (1) enhance customer protection; (2) produce a more efficient regulatory environment; and (3) permit greater innovation and economic benefits at one-third less cost to the taxpayer. Unfortunately, these benefits will not extend to the high pressure sales of non-exchange instruments.

As I noted at the outset, the activities this Committee is exposing are not part of the legitimate commodities industry. The firms that pedal these so-called "contracts" operate by choice and design outside the CFTC and industry self-regulation. Unfortunately their activities adversely reflect on the legitimate firms that are regulated by the CFTC, the exchanges, and the NFA. I commend this Committee's efforts to expose these fraudulent practices and the fact that they are being perpetrated by fringe elements using high pressure sales practices. The Board of Trade and I are sure the rest of the commodities exchange community is very willing to assist the Committee to eliminate these activities.

EXHIBIT NO. 11

TESTIMONY OF

KARL F. LAUBY

VICE PRESIDENT - OPERATIONS

THE BETTER BUSINESS BUREAU OF METROPOLITAN NEW YORK, INC.

Before the

United States Senate

Permanent Subcommittee on Investigations

on

Commodities Fraud

Karl F. Lauby
Vice President - Operations
Better Business Bureau of
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Submitted February 3, 1982

COMMODITIES FRAUD

Since the fall of 1975, the New York City Better Business Bureau has received inquiries and complaints on a network of more than 200 commodity firms allegedly using deceptive or fraudulent practices to sell worthless commodity and currency contracts. The volume of complaint and inquiry, the number of firms, the past track record of the promoters involved, the extent of the deception and fraud, the numerous law enforcement actions and media exposes - all these factors establish beyond any doubt that fraudulent boiler room commodity operations, taken in their entirety, represent the largest investment fraud of unsuspecting citizens in recent memory. It is likely that these "boiler room" schemes defrauded unsuspecting U.S. investors of over $100 million dollars a year.

The scheme is simple: A telephone salesman contacts a prospective investor promising a commodity deal that offers high profits at little cost with virtually no risk. With mailings of glossy promotional literature and phone calls of silver-tongued oratory, the promoter builds his credibility to obtain the confidence of the victim while changing his role from unknown salesman to trusted financial counselor.

Usually the promoters sold illegal option contracts. They disguised the identity of these options by inventing names for them such as "deferred delivery contracts," "forward purchase contracts," or "oil actuals." What the victim thought he was buying was in some cases an option covered by a futures contract of the physical commodity.

The record establishes that most firms neither owned nor controlled the commodities they sold. The investor did not know that. But the investor soon learned that after paying his money, the salesman rarely wanted to talk to him. When it came time to collect on what the investor thought was a contract representing a commodity, the company was gone. If perchance the investor had made money on paper at the time the contract matured and the company was still in business, the salesman convinced the investor to forego paper profits and invest more money.

These schemes started with London commodity options. Promoters then moved into "deferred delivery" contracts on both currencies and commodities when the Commodity Futures Trading Commission banned London commodity options. During 1979 and 1980, the favored commodity was oil. During 1981, strategic metals. During 1982, strategic metals continues to be a favorite, joined by a proliferation of commodity pool offerings.

The victims of these schemes come from every geographic, economic, education and investment background. Many of the victims are partially at fault themselves believing that they could make something for nothing. But primarily the victims fell prey to a sales pitch full of deception which they took for truth.

- An elderly California dairy farmer and his wife lost $22,500 on a deferred delivery contract scheme in gold and silver.
- Two Pennsylvania brothers lost nearly $100,000 on a phony gold and silver deal.
- A supermarket manager in a small Wisconsin town lost $180,000 on fraudulent gold, silver and heating oil deals.

The cleverness of these deceptions was only limited by the creativity of the promoter.

- One company, C. B. Benson Co., Inc., set up a phony commodity regulatory agency to give credibility to their deceptive operations. They called it the U.S. Commodity Bureau. When I called the phone number on July 11, 1979 posing as a potential investor, one "Richard T. Jones" told me that the U.S. Commodity Bureau was a watchdog agency that had known of C. B. Benson Co., Inc. for about 15 years, that the company had to apply to their agency for licensing, that the agency was a clearing house for consumer complaints, and that C. B. Benson was one of the "utmost reliable firms" that they knew of. Jones said that there are "stringent specifications" which the firms must meet for their agency. I thanked Mr. Jones for this reassuring information.

- On the evening of November 8, 1979, one John Vince explained that my investment in oil in Panama was secure because "we had our lawyers and Panama lawyers put together what we call an irrevocable revolving letter of credit." BBB investigation revealed that the bank that was supposed to administer this letter of credit had never heard of it.

These sales pitches were replete with pressure to make an immediate decision. Complainants wrote that they would often receive several calls at work in one afternoon with daily and even hourly reports of the increase in the value of the commodity that the salesman was trying to sell them.

In response to these proliferating telephone investment frauds, the New York BBB took several actions.

- Starting in 1976, we drafted a Solicited Persons Questionnaire and distributed it to the 154 Better Business Bureaus around the country, inquirers, complainants, and some law enforcement agencies. The objective of the Questionnaire was to obtain information from persons who had not yet been victimized but who had useful information about a sales presentation. In addition, we wanted to make sure that these inquirers asked the right questions instead of sending their money.

- Starting in 1976, we developed Subject Reports on London commodity options, deferred delivery commodity contracts, and strategic minerals. These reports provided general descriptions of the nature of the scheme and warned against involvement.
- We developed specific company file reports on individual firms. We attempted to report as soon as we could confirm deceptive practices that a firm had an unsatisfactory business performance record and did not meet Better Business Bureau standards of business practice.
- We alerted both editorial and advertising acceptability sides of the media to the deceptive practices of these firms. We cooperated with reporters in developing stories. We advised advertising acceptability departments as to the fact that the innocent advertisement often masked a company engaged in fraud.
- We informed law enforcement agencies of complaints and promotions coming to our attention. We worked closely with the U.S. Postal Inspection Service, the Federal Bureau of Investigation, the Commodity Futures Trading Commission, the New York County District Attorney, the New York State Attorney General, and the U.S. Attorney's Office. From 1977 through 1982, the BBB has referred numerous cases to

federal, state and local authorities. At one point in 1979, the U.S. Attorney's Office of the Southern District of New York copied our entire file containing documentation on several dozen companies. In addition, we have completed several affidavits based on first person investigations and testified at one criminal trial, that of Richard Neuberger of Neuberger Securities Corp.

It seems clear in looking at the pattern of deception and fraud perpetrated in the last six years that several things need to be done to prevent this kind of fraud:

- Registration procedures at the Commodity Futures Trading Commission should be improved. It is distressing that most of these firms were able to use the credibility of the United States government as an aid in perpetuating their schemes. These firms should not have been registered as commodity trading advisors or commodity pool operators. In many cases, the CFTC registration was a license to steal.
- Reparations procedures before the CFTC should be improved. Current reparations are producing default judgments against companies that don't bother to answer complaints because they are no longer in business. The victims are unlikely to collect anything.
- Local and state law enforcement agencies should be encouraged to move aggressively against boiler room operations.
- The CFTC should take a more aggressive role in educating the public on how to avoid being victimized by commodity fraud.

New schemes are born rapidly, and victims rarely see their money again. The BBB continues to investigate boiler room promoters in order to assist law enforcement agencies in their prosecutions, and alert the public to fraudulent schemes.

EXHIBIT NO. 11-Continued

ALABAMA SECURITIES COMMISSION

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THARPE FORRESTER
Commissioner of Insurance

February 19, 1982

The Honorable William V. Roth, Jr.
United States Senate
Chairman
Committee on Governmental Affairs
Senate Permanent Subcommittee on Investigations
Washington, D. C. 20510

Dear Senator Roth:

Your inquiry of the Attorney General of Alabama has been referred to the Alabama Securities Commission. The Commission is the Alabama agency charged with the responsibility of investigating and seeking the prosecution of investment-related frauds. The Commission's staff regularly investigates commodities-related frauds and is the single Alabama agency with the expertise and ability to follow the boiler room pitchmen who characterize commodities trading. Through its contacts with like securities agencies in other states under the sponsorship of the North American Securities Administrators Association, the Commission is able to track boiler room commodities frauds as they surface in other parts of the country.

As your staff is already aware, commodity boiler room operations are now and have been since the creaction of CFTC one of the major sources of fraud in this country. Alabama's experience with these type frauds has paralleled generally the national experience. In my opinion, the commodities fraud problem is a direct result of the preemption of state police powers and the vesting of exclusive jurisdiction in CFTC.

What had previously been a market reserved for sophisticated speculators and experienced farmers was transformed as a result of state law preemption into a pitchman's paradise where unsophisticated investors are hyped by fast-talking salesmen with little or no knowledge of the industry. Despite the creation of CFTC's exclusive jurisdiction over commodities transactions (or, more appropriately, because of it), boiler rooms touting commodity-related investments have burgeoned and prospered. Beginning with commodity options, continuing through silver and gold bullion sales, to deferred delivery contracts for crude oil and coal, and now into commodity pool frauds, boiler room operators and unscrupulous futures commission merchants have fleeced our nation's citizens of untold sums of money. These fraudulent schemes and rip-offs continue unabated. Following the infamous Lloyd, Carr and Company case, each passing year has witnessed an unchecked migration of thieves, con artists and swindlers to the commodities investment area.

The commodities frauds problem surfaced in Alabama during the investigation by the states of Massachusetts and Michigan of Lloyd, Carr and Company. Boiler room operators from Atlanta and Boston literally covered the state by phone seeking the funds of unwary and unsuspecting investors. Inexperienced salesmen were directed to tell customers anything to get the sale. Alabama citizens were told that they could expect to double, triple or quadruple their investment in a short period of time by investing in London commodity options.

Numerous boiler room marketing campaigns followed the Lloyd, Carr and Company example. Gold bullion schemes, schemes involving leveraged purchases of krugerrands, futures contracts for silver, futures contracts for Mexican Pesos, deferred delivery contracts for coal and crude oil, were all marketed to Alabama investors. The attached memoranda, letters and investigative reports should provide some insight as to both the number of scams and the diversity of the boiler rooms.

The exclusive nature of CFTC's jurisdiction served to inhibit formalized programs to combat commodity fraud by the Alabama Securities Commission. Initially, the Commission's investigators interviewed victims of these schemes and forwarded the reports of the interview, together with such documentary evidence as could be acquired, to the CFTC. This practice continued for several years. CFTC failed in most instances to even confirm receipt of the forwarded information and with less frequency ever informed this office of the ultimate disposition of any referred cases. In time it became abundantly clear that CFTC either could not or would not institute proceedings based on data referred to it by the state securities officials.

In light of CFTC foot-dragging, the Alabama Securities Commission turned its investigative efforts to assisting sister states to come to grips with boiler rooms located within their respective jurisdictions. Through the Enforcement Committee of the North American Securities Administrators Association and the Leviticus Project Association, Alabama investigators interviewed victims of boiler room sales in aid of on-going state investigations in New York, Massachusetts, Connecticus, Georgia, Tennessee and Kentucky. As scams were unmasked in joint investigations, the Commission from time to time published public warnings to alert prospective investors of potential fraudulent commodities trading practices.

During the years 1979, 1980 and 1981, the Alabama Securities Commission in cooperation with other agencies has directed its enforcement program to supporting civil and criminal cases brought by states in which the boiler rooms are found.

One indictment for theft by deception was obtained against a Memphis, Tennessee, commodities boiler room salesman who defrauded an Opp, Alabama, investor in connection with a silver bullion contract. The accused is a fugitive at the present time.

The Commission has not engaged in a single joint action with CFTC. The Commission, like most states, is, however, well aware of CFTC's position regarding the use of securities laws to protect Alabama citizens from fraudulent commodities-related schemes. CFTC's action in International Trading, Ltd. v. Bell, 556 S.W. 2d 420 (Ark. 1977), underscores their position. Additionally, the Commission is also aware of the 1981 CFTC cases involving the National Coal Exchange. That year, in response to an inquiry from Tennessee securities officials concerned over CFTC foot dragging on cases involving Memphis boiler rooms, CFTC officials acknowledged that state officials would run "a high risk of CFTC intervention" if they sought to proceed against the firms under any securities theory. Such threats, real and implied, serve very effectively to discourage state securities officials from employing securities theories against commodities boiler rooms.

Despite CFTC actions, this state's securities officials continue, through the North American Securities Administrators Association and the Leviticus Project, to conduct investigations of boiler room marketing companies. At present, investigations continue on the various coal exchanges in aid of the states of Kentucky, Gerogia and Tennessee.

Thus far, only one firm established a boiler room within Alabama. In 1977, International Trading Company set up a commodities boiler room in Birmingham, Alabama. They neglected, however, to first qualify as a foreign corporation to do business in Alabama. An injunction against the firm was obtained and later lifted after the firm returned all funds to investors and paid a $1,000 fine to the State.. Since that time, boiler rooms have been established in states outside Alabama. Alabama investors are solicited from these sites. Repeat violators are known to be active in those boiler rooms.

The Alabama Securities Commission and the Attorney General's office are funded by our legislature to enforce state law, not federal laws. The massive problems created by fraud in the commodities area will never be solved by injunctive actions in federal courts. When investors are induced to part with their funds because of lies and gross misrepresentations, a crime has been committed. Those who lie in order to steal investor funds must be prosecuted for what they are, thieves. They must be prosecuted in the jurisdiction where their victims reside. To do otherwise makes a mockery of the free enterprise system and the concept of an equal system of justice. A thief by any other name remains a thief. There is no valid reason why a thief who elects to sell commodities should be placed beyond the reach of state securities regulators. When thieves avail themselves of the protection umbrella of CFTC exclusive jurisidction, two things happen. First, legitimate commodities firms have a more difficult time doing business. Legitimate firms simply cannot compete with shady operators who dangle promises of high profits before the noses of unwary investors -- and this is the legitimate firm's money criminals are taking. This money could be employed for productive purposes instead of gambling on leveraged contracts for fool's gold.

Second, these criminals are also taking the credibility of legitimate firms. We are too well aware of the erosion of the public's trust and confidence in the business community, especially in the commodities investment area. It is, unfortunately, axiomatic that one bad businessman makes all businessmen look bad. The extent to which thieves maraud unchecked through the commodities markets inhibits the ability of legitimate firms to compete in these same markets. The ability of legitimate firms to compete in markets in which trading has become synonomous with fraud has been understandably injured.

State securitieis officials must be given the means with which to deal with thieves in the commodities field. In short, this Committee should recommend to the entire Congress that the states be given concurrent jurisdiction with CFTC over the commodities fraud area.

Sincerely,

Tom Krebs

TOM KREBS
Director

TK:hh

attachments

EXHIBIT NO. 11

STATE OF ALASKA

JAY S HAMMOND, GOVERNOR

DEPARTMENT OF COMMERCE &
ECONOMIC DEVELOPMENT
DIVISION OF BANKING, SECURITIES, SMALL LOANS & CORPORATIONS

POUCH D
JUNEAU, ALASKA 99811
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October 14, 1981

The Honorable William B. Roth, Jr., Del.
Chairman
Committee on Governmental Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Roth:

Your letter of September 11, 1981 to the Alaskan Attorney General regarding the Commodity Futures Trading Commission (CFTC) has been referred to this division for response.

Commodity option programs have been a problem in Alaska for the past ten years. By 1974 the problem was basically neutralized due to several actions taken by the Division of Banking and Securities and other states against unlicensed and fraudulent promoters. In 1975 with the advent of the CFTC and the preemption from state enforcement, the commodity con-artists came out of the woodwork and operated virtually unchecked in Alaska until the ban on commodity options in 1979 took effect. The presence of the CFTC in this state is and has been virtually nonexistent in spite of the many schemes perpetrated in Alaska primarily aimed at pipeline workers. It is the general feeling of the staff of the division and other Alaska white collar enforcement agencies that the CFTC, as presently composed, has acted as an aid rather than a hindrance to commodity fraud activities in this state.

The so-called permission to allow states to take action against commodity operators via the "amicus curiae" approach much publicized by the CFTC is, in practice, virtually impossible for a small state. The staff of the division has found that prosecutors are very reluctant to take on any commodity fraud case as long as the blanket federal preemption exists due to the possibility of having to fend off the federal government coming to the aid of the proposed respondent in order to defend its "turf", the complexities of preparing the case in light of federal involvement, and the question of whether any conviction or injunction would stand up due to the yet unresolved jurisdictional questions.

I submit for your committee's review that the blanket exclusion of state involvement in the commodities arena be modified to permit the states jurisdiction in the area of off-exchange activities. Alaska does not desire nor does it feel that it is necessary for the states to have separate regulatory standards over the activities of recognized exchanges. That should be one of the functions of the CFTC. Alaska also does not feel compelled to set licensing requirements for interstate commodity advisors, brokers and agents as long as the exchanges and/or the CFTC have set reasonable standards for these activities. However, we do feel a responsibility to try to protect the citizens of our state from unauthorized and illegal activities in the off-exchange and commodity pool commodities areas especially in the absence of proper federal action.

I shall answer your questions in the order posed:

1. Yes, there has been a serious problem in the area of commodity frauds since 1978 although this has been somewhat diminished since the ban on commodity options. Since October 1, 1978, this division has taken 8 administrative actions in order to stop such activities in Alaska. Even though our jurisdiction was and is in doubt, we felt compelled to take these actions to protect our citizens. It should be noted that all these activities were reported to the CFTC without any apparent responsive action on their part.

2. Specific programs implemented in Alaska have been through news releases, Cease and Desist Orders and informing complainants to contact the CFTC. We are not aware of any complainants who went through the CFTC who received proper satisfaction. Our deterrant program is not presently organized as it was prior to 1975 due to the fact that we feel that this should be one of the roles of the CFTC since they have the "teeth" and we are excluded from it.

3. No civil or criminal actions were taken by our division in 1979-81. There were 7 administrative actions during this period. These are:

   a. Metals Depository Corporation-Options on mineral commodities
   b. American Currency Exchange-Options on foreign currencies
   c. International Monetary Exchange-Future forwards in gold
   d. International Mining Exchange-Future forwards in gold
   e. Natural Resource Fund-Future forwards in mineral commodities
   f. California Trading Group-Managed commodity trading program
   g. American-Gold & Diamond Corporation-Future forwards in precious gems

4. One joint action. This was British American Options in 1977. The CFTC has never intervened in any action filed by Alaska as we have not filed any due to the preemption clause of the Commodity Futures Trading Act of 1974.

5. No current cases.

6. There have been several repeat violators. These were primarily "bucketshop" operators when option activity was running rampant. It should be noted that several of these operators were initally licensed by the CFTC even though the Commission has belatedly attempted to gain restitution in a few cases. At the height of options fraud activities (1975-79) the fact that a firm or party was licensed with the CFTC offered no assurances of protection to the Alaska investors.

7. This has been mentioned above. Basically, the problems are that no enforcement of illegal or fraudulent activities has taken place in Alaska because this state's hands are tied and the CFTC, either because of distance, lack of staff, or "bigger fish to fry", has failed to take any action in the state thus leaving Alaska wide open to fraudulent activities in this area.

8. We have not encountered any.

9. We agree that self-regulation following the pattern of the NASD-SEC approach is a very positive and viable alternative to CFTC regulation in the established and on-exchange area. However, self-regulation of those persons engaged in fraudulent off-exchange activities is a myth. It is these off-exchange activities that have caused the most problems for the individual states and, as stated above, Alaska does not feel it should be part of the on-exchange regulatory scheme, but that enforcement in the off-exchange area should be an option of the state.

10. The primary legislative recommendation to combat fraudulent activity in off-exchange transactions would be to eliminate the preemption clause of the Commodity Futures Trading Act of 1974 in relation to commodity pool operators and other off-exchange activities. I would also recommend that Congress require that the CFTC pursue a vigorous program of development of a self-regulatory body fashioned after the NASD as Congress initially ordered the CFTC to do several years ago. This has been very slow in coming to fruition. Congress might also consider a return to the provisions of the old Commodity Exchange Authority (CEA). There may have been problems under that approach, however, from the state's point of view, enforcement of fraudulent activities at the local level was much easier with the CEA in place than with the CFTC as presently constituted.

Thank you for requesting input in this matter from the individual states. It is gratifying to know that some legislators are concerned with the problems that we in the trenches face. If you require any further background information or details of individual cases, please feel free to contact me at any time.

Sincerely,

Willis F. Kirkpatrick
Director

JT/WFK/wfs 2/19

cc: Honorable Ted Stevens
United States Senate
260 Russell Office Building
Washington, D.C. 20516

Wilson Condon, Attorney General
Attention: Leslie Ludke
Pouch K
Juneau, Alaska 99811

Professor Joseph Long
University of Oklahoma
Law Center
300 Timberdell Road, #200
Norman, Oklahoma 73019

EXHIBIT NO. 11-Continued

Government of the District of Columbia
OFFICE OF THE PUBLIC SERVICE COMMISSION
451 INDIANA AVENUE, NW
WASHINGTON, D. C. 20001

RECEIVED
[illegible] 1982
[illegible]

IN REPLY REFER TO:

January 12, 1982

The Honorable William V. Roth, Jr.
Chairman, Committee on Government Affairs
United States Senate
Washington, D.C. 20510

Re: CFTC Jurisdiction

Dear Senator Roth:

The following is written in conjunction with the current inquiry by your Committee into fraudulent practices in the commodity futures industry and possible changes in the Commodity Exchange Act.

Very simply, the claim of exclusive jurisdiction by the CFTC over any and all commodity contracts has effectively curtailed the enforcement efforts of most states in this regard with the exception of those having staffs and budgets sufficient to fight the exclusive jurisdiction issue. There have been isolated cases where state securities agencies have successfully cooperated with the CFTC in joint enforcement actions. However, the experience of most states, I believe, has been uniformly negative insofar as developing any significant cooperative relationships with the CFTC. A year ago I was promised assistance by the CFTC in an investigation into the activities of a diamond promotion venture in the District of Columbia. Although we uncovered no evidence of fraud, the assistance from the CFTC never materialized.

Having been with the SEC in enforcement work for 9 years, it is my experience that state regulatory agencies are able to respond with greater speed to cases of fraudulent activities even though they are frequently limited in the scope of their investigations due to staff, jurisdictional and budgetary considerations. More to the point, I would submit that events in recent years have amply demonstrated the inability of any one agency to successfully combat fraudulent practices as pervasive as those in the commodity futures industry. The states of course, do not lay claim to, nor seek jurisdiction, over basic future contracts. They do seek at least joint jurisdiction in those instances where what is being offered would historically have been deemed a "security" as defined in the Securities Act of 1933 and thus essentially in all the states.

Cooperative enforcement between the several states and the SEC has made significant strides in the last 10-15 years with beneficial results to the investing public. Far from attempting to curtail the efforts of state securities agencies, the SEC has made increasingly greater efforts in recent years to encourage and support such agencies in all phases of enforcement effort.

As a practical matter, I do not personally believe that state actions brought pursuant to provisions under the Commodity Futures Trading Commission Act are a viable solution to the problems as voiced by the CFTC. The difficulty of developing expertise in a new statute alone ensures its impracticality. The proposition that a state agency should attempt to enforce a federal statute seems wholly inappropriate.

I submit that the issue boils down to - why exclusive jurisdiction? State securities agencies provide additional enforcement mechanisms in an industry which is demonstrably in need of further regulation and additional safeguards to an investing public that has lost untold millions attributable to fraudulent practices in recent years. The SEC has cooperated with the states with great success for many years and, with minor exceptions, there has been a notable absence of clashes over matters of jurisdiction.

The CFTC's failure to take advantage of the enforcement capabilities of the several states - indeed it has occasionally intervened directly to prevent such efforts - is an omission which can be corrected by Congress. I would urge that you and your Committee begin the process toward corrective legislation.

Very truly yours,

James F. Whitescarver, Jr.
Director of Securities

EXHIBIT NO. 11—Continued

JIM EDGAR
SECRETARY OF STATE

AUG. 26th 1818

OFFICE OF THE SECRETARY OF STATE
SPRINGFIELD, ILLINOIS 62756

January 13, 1982

Honorable William V. Roth, Jr.
United States Senate
Committee on Govermental Affairs
Senate Permanent Subcommittee on Investigations
Washington, D.C. 20510

Dear Mr. Roth:

This letter acknowledges receipt of your letter of November 13, 1981, wherein you have requested a response to ten (10) questions regarding commodity related fraud in the State of Illinois.

As administrator of the Illinois Securities Department, I am aware of the countless hours expended by the department in policing commodities schemes which have come within its jurisdiction. Further, as President of the North American Securities Administrators Association, Inc. I have been directed by the membership to seek ways for the organization to be of more assistance in enacting more effective regulation of those segments of the commodities industry which allows the perpetration of fraud upon the investing public of their states. The message of the citizen to his or her State Securities Regulator is clear, "Don't tell me about which federal or state agency has jurisdiction of the matter, or that it is a federal matter. I need help. I pay taxes. Where are you when I need you"?

The following paragraphs set forth responses to the questions outlined in your letter:

1. There have been several periods during the years 1975 through 1980 wherein commoditities fraud have caused particular concern to the Department. The problems did not involve commodity trading on regulated exchanges, but mainly new and quickly organized firms selling deferred delivery contracts. The extent of fraudulent activity cannot be readily ascertained as relatively few persons have come forward to complain. Most of this Department's enforcement actions resulted from the monitoring of "business opportunity" ads in financial and daily newspapers.

2. A commodity "hot line" was instituted in 1978 following the Lloyd Carr and Company scheme. The Department is currently monitoring financial and daily newspapers on an on-going basis. It should be noted that the gambling statute in the criminal code of Illinois provides that contracts to buy or sell commodities at a future date wherein the settlement is by the difference in prices, are construed to be gambling unless the same are handled by a broker or salesperson registered as the same. 38 Ill. Rev. Stat. 1979, Sec. 28 - 1 (4).

3. In the years 1979 through 1981 the Department initiated ten enforcement actions which resulted in administrative hearings. Documents evidencing these cases are attached hereto.

4. To date, no joint action has been initiated. The Department has referred numerous cases to the Commodity Futures Trading Commission (hereinafter "CFTC") for possible action. Mainly the referred cases were those concerning future'contracts sold on a registered market.

5. None

6. The only repeated violation in an enforcement action which we have undertaken concerns Transcontinental Petroleum Corp.

7. By statute, the Department is limited with regard to court actions. When criminal action is undertaken it is through the county state's attorney. Most subjects are based out of state and the action taken is the administrative prohibition order.

8. Information contained in the CFTC files regarding fraudulent activities within this State have remained undisclosed, and as such, enforcement efforts are at the sole descretion of the CFTC.

9. It would appear that the typical violator personifies the criminal stereo type and needs to be dealt with as such.

10. The Department is attempting to alert the commodity investing public as to illegal activities and fraudulent schemes. Increased coordination of enforcement activities with public relations sources is required.

Should you, or your committee members or staff persons, require any additional information, please contact either Gene Ring, Assistant Securities Commissioner or myself.

Very truly yours,

David Hart Wunder
David Hart Wunder by LEN
Securities Commissioner

DHW:sl

EXHIBIT NO. 11-Continued

STATE OF MICHIGAN

WILLIAM G. MILLIKEN, Governor
DEPARTMENT OF COMMERCE
P.O. BOX 30004, LAW BUILDING, LANSING, MICHIGAN 48909
NORTON L. BERMAN, Director

CORPORATION & SECURITIES BUREAU
6546 Mercantile Way
P O Box 30222
Lansing, Michigan 48909
(517) 374-9417

January 26, 1982

The Honorable William V. Roth, Jr., Chairperson
United States Senate
Committee on Governmental Affairs
Senate Permanent Sach Committee on
  Investigations
Washington, D.C. 20510

Dear Senator Roth:

The Michigan Corporation and Securities Bureau recently received a copy of your letter of September 11, 1981 to the Maryland office of the Attorney General regarding problems which exist in the commodities exchange market. We would like to take this opportunity to add our thoughts on the matter.

This agency has adopted a position in light of the current preemptive language in the Commodity Exchange Act that when investor complaints are received which involve commodities, such complaints are to be forwarded or referred to the Commodity Futures Exchange. Many of these complaints would involve a violation of our state's securities statute but for the preemptive language of the Commodity Exchange Act. As a matter of policy, we have determined that it would not be the best use of our limited resources to attempt to enforce the federal statute in federal court.

We are aware of numerous complaints dealing with off-exchange transactions. The central problem appears to be that many investors are being placed in this market when this particular type of investment is clearly unsuitable for the parties involved. Although the Commodity Futures Trading Commission discussed the possibility of adopting a suitability rule or standard comparable to the "Know Your Customer" rule in the securities industry, no such rule has been adopted. The result of this is that unsophisticated investors are pressured into placing all, or a major part of their savings, into a highly speculative market as a consequence of representations that they are certain to receive spectacular returns on the investment.

The preemption language of the Commodity Exchange Act creates a dilemma in determining when that Act is applicable as opposed to the securities laws. In the past several years, the Bureau has encountered several situations where it has been forced to forgo enforcement actions for activities which are violations of the state's securities statute because the party was able to make reasonable arguments that the activity falls under the Commodity Exchange Act, thus the state was without jurisdiction under it's securities statute.

Sincerely,

E C Mackey

E.C. Mackey, Director
Corporation & Securities Bureau

ECM:CLT:mm

EXHIBIT NO. 11-Continued

State of Wisconsin \ OFFICE OF THE COMMISSIONER OF SECURITIES

Lee Sherman Dreyfus
Governor

Richard R. Malmgren
Commissioner of Securities

Stephen L. Morgan
Deputy Commissioner

111 WEST WILSON STREET
BOX 1768
MADISON, WISCONSIN 53701

GENERAL (608) 266-3431
REGISTRATION (608) 266-3431
LICENSING (608) 266-3693
FRANCHISE (608) 266-3364
ENFORCEMENT (608) 266-8557

January 15, 1982

Honorable William V. Roth, Jr.
United States Senate
Committee on Governmental Affairs
Washington, D.C. 20510

Dear Senator Roth:

Re: Commodities Fraud

It has come to my attention that on September 11, 1981, you forwarded an inquiry regarding commodities fraud in Wisconsin to Wisconsin Attorney General Bronson C. LaFollette. Assistant Attorney General Michael L. Zaleski responded to the inquiry on September 28, 1981.

I would like to take this opportunity to supplement that response. During the period of October 1, 1978 through December 31, 1981, my Enforcement Division has fielded a multitude of inquiries and complaints from residents of this state regarding the offers and sales of so-called "off-exchange instruments" by numerous firms and their agents. The Enforcement Division has amassed a great deal of information in its dealings with these residents, the firms, the Commodity Futures Trading Commission and the securities agencies of other states, providing a broad base of experience in the area.

I will attempt to respond to each question presented in your letter of September 11, 1981.

1. In my view, commodities fraud in Wisconsin has been a very serious problem since October 1, 1978, and probably was prior to that date as well. Combining the gold, silver, foreign currencies, petroleum, strategic metals and coal frauds, my staff estimates that during the period in question, Wisconsin investor losses reported to this Office were in excess of $240,000.

2. We have instituted a program of press releases and media contacts, seeking to inform the public of the dangers of investing with firms offering such investment opportunities. A toll-free, 24

hour investor "hot-line" was created by the agency in conjunction with this program. Although adopted to deal with all forms of investment fraud, the program has had particular success in confronting the more flamboyant sales practices of the deferred delivery contract promoters. In addition, we have continued the practice of referring each inquiry or complaint to the CFTC.

3. This agency has not instituted any civil or criminal actions regarding such frauds.

4. The State of Wisconsin has not jointly filed any actions with the CFTC. To my knowledge, none of the persons and companies engaging in this type of commodities fraud has ever been located in Wisconsin. This is a state of victims. The CFTC has not had occasion to intervene in any action brought by Wisconsin.

5. My staff is currently investigating National Coal Exchange, Inc., American Coal Exchange, Inc. and Conticoal Resources Exchange.

6. There have certainly been repeat violators in Wisconsin. In addition to the fact that various firms and individuals carried on their frauds over periods of time, my staff has detected facts leading to the conclusion that different fraudulent conduct has been perpetrated by the same individuals. As an example, 2020 N.E. 163rd St., North Miami Beach, Florida has been an address connected with numerous gold, silver, foreign currency, petroleum, securities and strategic metals frauds, generally linked to Ronald Nagorniak and Robert Shoher over the years.

7. Wisconsin enjoys a national reputation as a leader in securities law enforcement. Our enforcement program has as one of its tools the administrative order. These orders may be issued summarily, by stipulation or following a hearing. Wilful violation of an administrative order is a felony offense under Wisconsin law. Orders have proven to be an efficient and effective means of coping with securities law violations emanating from both within and outside our borders.

The federal pre-emption of state securities laws included in the Commodity Exchange Act denies Wisconsin the use of its administrative order power against commodity frauds. Administrative subpoena power is also pre-empted. Therefore, two proven means of dealing with investment fraud are unavailable to us. Such a result is most unfortunate.

Pre-emption created a void in the regulation of the commodities industry which the CFTC has been incapable of filling. Commodities boiler-rooms have flourished under the present scheme of regulation. Joint state-CFTC actions are only feasible when the targets are present in the state concerned. As previously stated, Wisconsin has been a state of victims, not violators. Pre-emption denies us the very weapon against such schemes - the administrative order - that has proven so effective in the securities field.

I do not believe that the sole cause of the proliferation of commodities boiler-rooms is pre-emption. It has merely been the whipping boy for more fundamental problems. Federal commodities legislation is weak, confusing and ambiguous. The CFTC does not have the physical or legal resources to respond quickly and completely to the fraud merchants they are now charged with regulating. These frauds have been perpetrated by criminals, not mere regulation violators, and law enforcement tools must be developed to comprehensively confront and defeat this white collar crime wave. While I believe the marketplace would be better protected if pre-emption was eliminated, I do not believe such an act would in itself be a complete answer to the problem.

8. The staff has not experienced any problem regarding disclosure of information by the CFTC. However, we have not sought such information.

9. Self-regulation might have the effect of heightening the general perception of the commodities industry as a regulated field. This would certainly be of benefit. The severity of the commodities fraud problem has had a disparaging effect on all commodities firms and investments, and a self-regulatory body might have a vested interest in eliminating the problem of off-exchange transactions. However, effective self-regulation takes time and strict oversight from governmental regulators during its implementation. I do not believe self-regulation is a viable alternative to CFTC regulation, but rather a promising and potentially valuable addition to CFTC, and hopefully, state regulation.

10. Jurisdictional ambiguities must be unequivocally eliminated. The pre-emption of state securities laws must be removed. Legislation must be adopted that clearly addresses the off-exchange instrument crisis. Congress must mandate that the CFTC, the FBI and the U.S. Attorneys Offices across the country confront this problem, and then

must provide the manpower and funding necessary to cope with a national crime on a national basis. Some form of summary or cease and desist order authority may prove to be an effective tool, as it has worked well at the state level. In addition, an effective and expedited reparations procedure must be adopted.

I cannot over-emphasize the seriousness with which I view the abominable record in combatting commodities fraud. I have taken the liberty of enclosing two reports prépared by the staff of the Enforcement Division of my Office . The reports contain a Summary of Deferred Ddelivery Contract Activity in Wisconsin during the period 1978 through 1981, and a compilation of complaint letters received by the staff on the subject from Wisconsin residents during the period. I trust you will be impressed with the seriousness of the problem here in Wisconsin as one representative state.

I thank you for your interest and for allowing me to supplement the previous response to your inquiry by the Wisconsin Attorney General. It is the hope of every securities administrator that the U.S. Senate comprehensively addresses these issues and produces effective means of resolving them.

Should you have any questions or comments, please do not hesitate to contact me at the above address or directly at (608) 266-3433.

Sincerely,

Richard R. Malmgren

RICHARD R. MALMGREN
Commissioner of Securities

RMM/PAF:mad

Enclosure

EXHIBIT NO. 11-Continued

STATE OF DELAWARE
DEPARTMENT OF JUSTICE
STATE OFFICE BUILDING
820 N. FRENCH STREET, 8TH FLOOR
WILMINGTON, DELAWARE 19801

RICHARD S. GEBELEIN
ATTORNEY GENERAL

DIRECT DIAL:

DEC 28 1981
RECEIVED
DIVISION OF SECURITIES

September 18, 1981

Honorable William V. Roth, Jr.
Chairman
United States Senate
Committee on Governmental Affairs
Senate Permanent Subcommittee
on Investigations
Washington, D.C. 20510

Dear Senator Roth:

Thank you for your letter of September 11, 1981 concerning Delaware's experience with commodity fraud activity.

The specific questions you asked are answered below in the same numerical order.

1. We believe there is a nationwide problem with commodity fraud. Many state Security Administrators believe that the commodity area has been the most rapidly growing area of fraud in the last ten years. The products vary from strategic metals to coal during the energy crisis and gold and silver during the precious metal craze. We have no figures showing the impact on Delaware. Since October of 1978 the Securities Division has however received about one inquiry on this subject each month.

2. To warn investors against commodity fraud, the Delaware Securities Division arranged for a feature article in the Wilmington newspapers in early 1980. This was followed by a widely disseminated 16 page "Investors Warning Bulletin" covering boiler-room type schemes and other commodity fraud problems. In addition, Donald L. Bruton, Securities Commissioner, talked before local groups emphasizing the problem.

3. This Office has brought no civil or criminal actions involving commodity fraud during the past three years. The Commodities Future Trading Commission (CFTC) has exclusive jurisdiction over most commodity matters and they also have brought no civil or criminal action in Delaware since 1974. Most enforcement cases are filed at the location of the offense. We have had no evidence of offenders being based in Delaware.

4. There were no joint State of Delaware/CFTC actions filed and the CFTC has never intervened in a Delaware case. Several years ago there was an instance where the CFTC intervened against Arkansas on behalf of one being sued (International Trading Limited v. Bell, 556 S.W.2d.420 (1977). This action caused concern among State Securities Administrators.

5. There is one case involving a coal exchange and a reported local salesman that the Securities Division is currently investigating. It is our practice to refer all on-exchange cases to the CFTC since they have exclusive enforcement jurisdiction.

6. We know of one firm (on-exchange) that was a repeat violater in Delaware.

7. We have not been affected by the requirement under the Commodity Exchange Act that most if not all commodity actions be instituted in Federal court. In larger states more directly involved with boiler-shop operators exclusive Federal court jurisdiction may have handicapped State enforcement jurisdiction.

8. Delaware has not been affected by Section 8(e) of the Act which authorizes disclosure of information by the CFTC to federal authorities only. If a commodity fraud operation were located in Delaware we would be handicapped by this failure to share information.

9. No. Self regulation by the commodity industry would not be likely to eliminate fraudulent activities in off-exchange transactions.

The Department of Law
State of Georgia
Atlanta
30334

MICHAEL J. BOWERS
ATTORNEY GENERAL

EXHIBIT NO. 11-Continued

December 30, 1981

The Honorable William V. Roth, Jr., Chairman
Committee on Governmental Affairs
Senate Permanent Subcommittee on Investigations
Washington, D. C. 20510

Dear Senator Roth:

Our office has thoroughly reviewed your letter concerning fraudulent activity in the commodities futures industry dated September 11, 1981. In that letter you requested specific responses to particular questions. Specifically, our office would respond as follows:

1. It is our view that there has been a serious problem of commodity fraud in the State of Georgia since October 1, 1978.

2. Commodity fraud has been combated primarily under the Georgia Securities Act of 1973 as amended.

3. In 1979, 1980 and 1981 our office brought one civil commodity action jointly with the CFTC. *CFTC and State of Georgia Ex Rel. Arthur K. Bolton v. Sterling Capital Company, et al.*, Civil Action No. C80-835A in the United States District Court for the Northern District of Georgia. No criminal cases have been brought in this period. However, numerous administrative cases have been handled under the Securities Act by the Secretary of State of Georgia in his capacity as Commissioner of Securities. In these cases our office did not directly participate, but acted as legal counsel for the Commissioner.

4. Our office has participated in one action jointly with the CFTC, the *Sterling* case shown above. To our knowledge the Commission has never intervened on behalf of a party being sued by the State of Georgia.

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AVAILABLE COPY

5. Our office does not have an investigative staff, and as such in general does not investigate cases. Cases under the Securities Act are investigated by the Secretary of State - Commissioner of Securities.

6. It is our understanding from information given to us by the Secretary of State's office that there have been repeat violators in the State of Georgia.

7. The limitation of the Commodities Exchange Act which requires most commodities actions to be instituted in federal court has been somewhat of a limitation as our state courts are somewhat more speedy in disposing of pending cases.

8. At present, Section 8(e) of the Commodities Exchange Act which authorizes disclosure of information by the Commission has not created any significant problems in the State of Georgia.

9. In our view self-regulation by the commodity industry is not a viable alternative to CFTC regulation in that most fraudulent activity is caused by entities resisting CFTC regulation or other supervision.

10. Our office might suggest that the Commodity Exchange Act be amended to allow State Attorneys General to use this Act in their own state courts. This action would not change the substance of the Act but would allow the Attorneys General somewhat more flexibility in dealing with commodity fraud.

I do trust that this has been responsive to your inquiry. I will look forward to working with your office in any way possible to assist in your efforts against fraudulent activity in the commodity futures industry.

Thank you for your consideration in requesting our views on the matters before your committee.

Sincerely,

Michael J. Bowers

MICHAEL J. BOWERS
Attorney General

MJB/WDH/jw

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EXHIBIT NO. 12

PARKER AUSPITZ NEESEMANN & DELEHANTY
415 MADISON AVENUE
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JOHN M. DELEHANTY
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CHARLES S. BARQUIST
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TELEPHONE: (212) 355-4415
CABLE: "PARAUNDEL" N.Y.

November 17, 1981

The Honorable William V. Roth, Jr.
Chairman
United States Senate
Committee on Governmental Affairs
Senate Permanent Subcommittee
 on Investigations
Washington, D.C. 20510

Re: Commodity Futures Trading
Commission v. Fairchild, Arabatzis &
Smith, Inc.

Dear Senator Roth:

I hope that the following information concerning my activities as Receiver is of assistance to you and your Committee. Since, in my opinion, the Receivership vehicle is not an efficient or effective method of protecting public investors (at least within the factual context in which I operated), I have attempted to set forth what has transpired in some detail. I would, of course, be happy to amplify any of the information contained in this letter, or to meet with you or members of your staff to furnish you with additional information or to supplement this presentation.

On April 27, 1979, I was appointed Equity Receiver for Fairchild, Arabatzis & Smith, Inc. ("FAS"), Astor & Montcalm, Inc. ("AM"), and Steven M. Arabatzis ("Arabatzis") in an action brought by the Commodity Futures Trading Commission ("CFTC") in the United States District Court for the Southern District of New York entitled Commodity Futures Trading Commission v. Fairchild, Arabatzis & Smith, Inc., Astor & Montcalm, Inc., Steven M. Arabatzis, Barry R. Doscher and Robert F. Feuillebois, seeking injunctive, ancillary and other relief.

FAS and AM, under the direction of Arabatzis, had been involved in fraudulent sales of London commodity options, commodity pool participations, and contracts for deferred delivery of gold which resulted in losses of about $6,000,000 by approximately 1300 people located in 45 states, the District of Columbia, and Canada.

On October 11, 1978, approximately six months prior to my appointment, FAS and AM ceased large scale public sales following the execution of a search warrant at FAS and AM's offices at 63 Wall Street, New York, New York by United States Postal Service officials that resulted in the seizure of, inter alia, over 100 boxes of FAS and AM documents.

Following these events, two of the principals of the company, Arabatzis and Robert F. Feuillebois, were indicted. See United States of America v. Steven M. Arabatzis, 79 Cr. 86 (KTD); United States of America v. Robert F. Feuillebois, 79 Cr. 260 (KTD). On February 15 and March 9, 1979, Arabatzis pleaded guilty to four counts of mail fraud and was sentenced by Judge Kevin Duffy to two consecutive five-year prison terms. Feuillebois was sentenced to a period of probation.

In the Court's Order of April 27, 1979, appointing me Receiver, I was, among other things, directed to:

1. Take into my custody and hold pending further Court Order all assets and property belonging to FAS, AM, and Arabatzis;

2. Prosecute claims belonging to FAS and AM; and

3. Make an accounting with appropriate professional assistance, of all assets and liabilities of FAS and AM, and all funds received and paid out by them.

These activities are ongoing and are being accomplished with the assistance of Court-appointed counsel and accountants.

Based on our investigation and information generated by the United States Attorney's office, we learned that FAS and AM received from customers during the period February, 1977, through October, 1978, approximately $5.5 million.

Although a substantial portion of these funds was apparently expended in the course of business by FAS and AM on activities such as commissions, salaries, telephones, etc., much of that money was not spent for proper business purposes and cannot presently be accounted for. At the time of my appointment, insofar as I have been able to determine, no funds, with the exception of $9,991.89 on deposit in the Chase Manhattan Bank, were on deposit in any bank accounts maintained in the name of FAS, AM, or Arabatzis, and the physical assets of those entities--e.g., office equipment and furniture--had disappeared as well.

Since my appointment, my activities have been primarily devoted to searching for assets and attempting to identify viable claims existing on behalf of FAS and AM. This task has been significantly exacerbated by several factors. First, substantial amounts of investor funds disappeared through the efforts of sophisticated criminals (Arabatzis and Feuillebois). Secondly, six months elapsed from the Postal Service's raid in October, 1978, and my appointment in April, 1979, during which period the former principals of FAS and AM were in control of its assets and activities. This interval has made the difficult task of tracing assets and obtaining information even more difficult. Thirdly, the whereabouts of certain key FAS and AM employees who might shed light on the companies' activities is unknown. Fourthly, in instances where FAS and AM personnel and others working for the companies who have been located and subpoenaed (where necessary) and produced information, that information, while at times useful, was in other instances inaccurate, incomplete, or misleading. Where information concerning the amounts and recipients of payments of funds has been secured, it has, in most instances, been impossible to determine whether those payments were for goods actually supplied or services actually rendered or for improper purposes.

Factual Background of the Operations of FAS and AM

Between April, 1977, and October, 1978, Arabatzis conducted a boiler-room operation which sold fraudulent commodity investments to hundreds of people throughout the United States. In April, 1977, "Fairchild, Arabatzis & Smith, Inc." was incorporated and obtained a license from the CFTC to operate as a Futures Commission Merchant.

After furnishing offices at 63 Wall Street, Arabatzis hired about ten salesmen, some of whom were licensed to sell commodities and some of whom were not. Arabatzis provided them with written sales presentations which they delivered in unsolicited telephone calls to persons whose names had been purchased from Dun & Bradstreet. Most of the solicitees lived outside of the New York metropolitan area. The initial calls falsely portrayed the commodity investment as an opportunity to make substantial profits. The initial call was followed by a mailing of literature containing misleading information. Salesmen thereafter made follow-up calls. The "closing" presentation, intended to finalize the sale, was usually entrusted only to the most experienced salesmen, who then shared a commission with the inexperienced "fronter".

Where there was sufficient time before the customer realized that he had lost his money, salesmen recontacted the customer to induce him to send more money for more investments. In this process, called "reloading", the customer deceptively was told that his earlier investment had "equity". Such statements were designed to suggest that the first investment had already resulted in profits. This false inducement frequently succeeded in obtaining additional funds.

Although different fraudulent approaches were used by Arabatzis at different times, the basic one remained the same, with each generating substantial profits for Arabatzis and his salesmen, and virtually total losses for investors.

The sale of London commodity options was a common device used by Arabatzis. During the 12-month period that FAS sold London commodity options, it succeeded in inducing approximately 1,000 people to buy $4,393,345.17 worth of options. Only $221,851.86 of this money was returned to customers.

The key aspect of the options scheme was that Arabatzis sold the options with unwarranted predictions of enormous profits. The option was a losing investment for the customer in large part because its cost was distorted by FAS's exorbitant commissions, amounting to mark-ups of up to 100 percent of the purchase price. Arabatzis was able to charge such commissions because of an absence at that time of regulatory controls, and because members of the public whom he contacted generally knew nothing about commodity options, other than what FAS told them.

The FAS telephone solicitations failed to inform potential customers that half, and sometimes more than half, of an investment would constitute commission income for FAS. FAS's written promotional materials, sent by mail, concealed FAS's commission by calling it a "Foreign Service Fee". On the whole, the options customers had little notion of what they were buying, and they sent their money in reliance on the totally unwarranted predictions of enormous profits which Arabatzis and his salesmen continuously made.

Between April, 1977, and the fall of 1977, Arabatzis constructed one of the largest boiler-room operations in the City, with as many as 40 to 60 salesmen making telephone solicitations. A night crew was employed for evening solicitations. During this period, gross sales were in the range of $175,000 to $200,000 per week.

In February, 1978, Arabatzis began to sell participations in commodity pools. The scheme lasted through the late spring, during which time Arabatzis managed to raise and dissipate $647,000 in customers' funds.

Arabatzis used his standard sales tactics to sell participations in pools, each of which was to consist of $50,000 contributed by no more than 30 investors for joint investments in commodity futures, stressing to potential investors that these pools would provide the benefits of a mutual fund.

As with the options scheme, FAS imposed exorbitant commission charges on the pool investments that virtually insured that the pools would yield substantial commissions and no returns to the customers. Customers were charged $150 to $300 for each trade executed on behalf of the pool account. However, FAS was not itself a clearing member of any commodity exchange and could not execute trades on behalf of the pool accounts. Thus, the pool accounts had to be traded through a member firm, which charged the accounts about $40 for each trade executed. Arabatzis' additional charge of $150 to $300 per trade greatly reduced the possibility that the pools would yield any profit.

While high commissions diminished the pools' prospects for profits, churning guaranteed their rapid demise. Shortly after the first pools were established, FAS began to use them as a vehicle to obtain the income to meet weekly expenses. Thereafter, FAS ordered excessive trading for the pool accounts for the primary purpose of generating commission income, but at the same time rapidly causing total losses for customers.

Of the $300,000 invested in the first six pool accounts, which were initially traded through Shearson Hayden Stone, only $86,746.50 remained after about five weeks. FAS had taken $76,561.50 in commissions, Shearson has taken $28,758 in commissions, and about $108,000 had been lost in trading.

The remainder of those accounts was then moved to another brokerage house, Macro International, where FAS's "trader" was given a desk. Arabatzis called the trader each morning and gave him instructions as to the number of trades to be executed in the pool accounts on that day. During this period--mid-April through mid-May, 1978--the FAS salesmen raised an additional $347,000 for new pool accounts. Within the same weeks, most of that money was churned out, with FAS taking $245,532 in commissions.

Toward the end of the pool schemes, FAS began direct embezzlement of customers' money. On May 10, 1978, Arabatzis took $84,000 in customers' funds and used it for corporate expenses. To cover deficits at Macro created by this embezzlement, Arabatzis had all the remaining funds in the pool accounts combined, offsetting the credits and debits of the various accounts. FAS then apparently ordered its bookkeepers to make false entries in FAS's books, covering up the embezzlement and giving each pool a small, fictitious credit balance of $350. Pool participants, who thereafter sought to retrieve their investments, were told that their share of the pool was some percentage of that fictitious $350 credit balance. In the pool scheme, 178 investors were defrauded of a total of $647,000. Some $10,000 was returned to 32 investors.

At about the same time FAS began sales of pools, it also opened the "gold room" for the sale of contracts for deferred delivery of gold. This operation was conducted under the name, Astor & Montcalm, Inc. Boiler-room techniques similar to those used at FAS were used at AM.

The contracts for deferred delivery of gold purported to give the customer the right to buy gold at a particular price approximately six months after the purchase of the contract. Initially, FAS charged fees of approximately $2,500 for such contracts. Later, the fees were substantially more.

FAS imposed monthly finance and "storage" charges on customers' investments that were designed to offset any rise in the price of gold during the contract period. Initially, such charges were 1 percent per month. Later, when the price of gold rose sufficiently to overcome that monthly charge, FAS changed the monthly charge from 1 percent to 2 percent.

Between February and October, 1978, 143 AM investors paid $942,142.50 for gold contracts. Only eight investors received money back, and they received, in total, only $1,887.50.

During this same period, Arabatzis devised and executed another scheme, known as "no margin straddles", to defraud the public investors. Again, using false predictions of profits and playing on the ignorance of the purchaser, the FAS salesmen sold the customer a commodity straddle--consisting of long and short futures contracts--for an exorbitant price that eliminated any possibility of profit for the customer. Straddles available for $100 and $200 from legitimate brokerage houses were sold by FAS for $4,900. This scheme resulted in more than $500.000 in losses to investors.

The office of the United States Attorney concluded that during the 18-month period in which Arabatzis was operating FAS and AM, his personal profits exceeded $600,000. In October, 1978, Arabatzis informed that office that he had between $200,000 and $250,000 in cash in a safe in his home. At that time the United States Attorney's office also learned that apparently FAS and AM had assets amounting to more than $50,000 in the form of credit balances, security deposits, and office equipment. By the time of his sentencing in late May of 1979, Arabatzis claimed to have only $3,500 to $4,000 left. He produced documentation to the United States Attorney's office showing expenditures of approximately $100,000. By the time of my appointment and at his deposition, Mr. Arabatzis swore that virtually the entire sum of money had been spent.

Arabatzis claimed that following the closing of FAS and AM by federal authorities in October, 1978, he opened a company known as National Trade Exchange, Inc. at 562 Fifth Avenue, New York, New York. According to Arabatzis, National Trade Exchange dealt in commodities "actuals" or "physicals".

He indicated that the company "never got off the ground", that approximately $100,000 was invested in National Trade Exchange, and that the entire money was spent primarily in various forms of advertising in Playboy Magazine, The National Enquirer, Moneysworth, National Business, Grit Magazine, and The Star. He also stated that a portion of those funds was invested in the preparation and mailing of promotional material concerning National Trade Exchange. He testified that all checks, documents, and so forth, etc., pertaining to National Trade Exchange were still on the premises. A visit to the premises indicated that the premises had been reclaimed by the landlord and were in the process of being refurbished. Apart from miscellaneous promotional material relating to National Trade Exchange, no information pertaining to the whereabouts of assets was found at the premises.

Activities of the Receiver

Immediately upon my appointment, I made arrangements to meet with members of the staff of the CFTC and of the United States Attorney's office to make a preliminary investigation of facts. I acted to freeze FAS's, AM's, and Arabatzis' bank accounts at each of the institutions at which I was able to identify that those entities maintained accounts. Those institutions were Chase Manhattan Bank, Chemical Bank, Citibank, Bank Leumi, Manufacturers Hanover Trust, Lloyd's Bank International Ltd. and Barclay's Bank. With the exception of $9,991.89 on deposit in an FAS account at Chase Manhattan Bank, which was obtained by me, the other institutions reported no FAS, AM, or Arabatzis funds on deposit.

I also learned that during the Postal Service's raid on FAS's offices, among the assets seized, were gold coins and a gold bar. I made arrangements with the United States Postal inspectors, who had possession of the gold, to have it transferred to me. On October 3, 1978, the gold was sold through a metals dealer for a total yield of $52,492.44.

During my investigation, I learned that FAS maintained a safe deposit box at the Chase Manhattan Bank and that Arabatzis maintained one at the Dollar Savings Bank. In January, 1980, I petitioned the Court for an order directing the opening of the boxes; and they were forced on January 31, 1980 (Chase), and February 7, 1980 (Dollar Savings). The Chase box was empty and the Dollar Savings box contained apparently irrelevant miscellaneous paper.

During an interview with Mr. Arabatzis, my counsel learned that shortly before his sentencing, Arabatzis gave to an accounting firm certain records pertaining to his activities after October, 1979. I obtained a Court order authorizing me to take immediate possession of the documents. Possession was obtained and the documents were analyzed but proved to be relatively valueless.

Concurrently with these activities, intended to marshal estate assets, I took the deposition of various entities and individuals employed by FAS or known to have provided various services to FAS. On May 3, 1979, I took the deposition of Steven M. Arabatzis. On June 8, 1979, the deposition of Marc Reichman, a former accountant of FAS, was taken. On June 18, 1979, the deposition of Macro International Group, Inc. by Kenneth Ennis was taken. On July 2, 1979, the deposition of Vespoli, Shukla & Co., an accounting firm engaged by FAS, was taken. In connection with each of these depositions, subpoenas were issued requiring deponents to produce records and documents pertaining to their dealing with FAS, and any related entities. Pursuant to these subpoenas, voluminous documents were collected and analyzed by me.

Concurrently with these depositions, I made arrangements to obtain access to documents pertaining to Shearson Hayden Stone's work for FAS. These documents, primarily relating to Shearson's work for the FAS pool accounts, were obtained and analyzed by me. In addition, I was able to make a preliminary review of documents at the offices of counsel to Arabatzis, FAS, and AM.

As previously noted, as a result of the raid on the FAS premises, United States postal authorities seized more than 100 boxes of documents relating to FAS and AM. These documents were in storage at the office of the United States Attorney. A major project in connection with my search for assets was the review of these documents. They consisted of more than 15 file drawers containing customer files, trading information, employee and payroll records, bank statements, and other material. These documents were reviewed in an effort to generate information concerning the whereabouts of FAS assets and the identify of individuals or firms who were likely to be able to shed information on the whereabouts of FAS and AM assets. In addition to the actual review and analysis of possibly helpful documents, I and my counsel had numerous conferences with the Assistant United States Attorney who had been in charge of the FAS investigation.

The Receiver's Activities Relating to Customers of FAS and AM

Since my appointment, I have received ongoing written and telephone inquiries from customers of FAS and AM concerning the status of their investments. During the first few months of the Receivership, two or three such phone calls were received on an average day. In addition, correspondence has been received from investors and their counsel. Those inquiries necessitated oral and written responses concerning the status of specific accounts and the status of the estates generally. This activity required, on many occasions, researching at the United States Attorney's office questions and inquiries from customers and the preparation of responses to such inquiries. In addition, I frequently received inquiries from other governmental authorities, such as the Internal Revenue Service, about various matters pertaining to the Estate. Again, these inquiries had to be considered and dealt with.

CFTC Reparations Proceedings

An even more substantial problem was posed by the fact that some forty separate administrative reparations proceedings relating to FAS and AM have been filed with the CFTC. The Commodities Futures Trading Act, 7 U.S.C. §18, provides for an internal CFTC administrative adjudication mechanism for investors who believe they have been defrauded by commodities houses, pursuant to which numerous separate reparations proceedings were instituted by investors.

Initially, the CFTC was of the view that I had the responsibility of responding to, and dealing with, reparations complaints on behalf of the entity with whom the customer dealt, i.e., FAS and AM. This placed me in the position of being a party to forty separate administrative proceedings. The Commission, after my appointment, forwarded reparations files to me. In many instances, time limits were imposed for responses to reparations complaints. In other instances, the time limites had passed prior to my appointment. Initially, I was obligated to act as party with respect to each of these 40 matters. This meant setting up and organizing docket sheets to keep track of submission deadlines in the various proceedings and attempting to investigate the complaints to determine whether responses were possible.

Initial efforts to deal in this matter with reparations proceedings indicated that the meager estate assets would soon be totally dissipated if I were required to participate in reparations proceedings. Moreover, as I more fully understood the facts involved, it became apparent that reparations proceedings designed to prove that defrauded investors were, in fact, defrauded were likely to serve no useful purpose.

Therefore, I negotiated with members of the reparations unit of the CFTC in Washington concerning the proper handling of this problem. After an interim stay of reparations proceedings expired, in early October, 1979, I petitioned the Court for a judicial stay of reparations proceedings pending the completion of the Receivership. The Commission formally objected to the request on the grounds that the Court lacked jurisdiction to stay administrative proceedings. A compromise was reached under which I, in late October, 1978, on notice to all parties to reparations proceedings, petitioned the CFTC for a stay. The Commission agreed to stay such proceedings through April, 1980. However, my communication with investors concerning reparations proceedings triggered numerous telephone calls and written inquiries about reparations proceedings from investors who apparently had expected such proceedings to be an effective way of securing redress for their losses.

In addition to the problem of reparations proceedings, I am also technically a party to an administrative action brought against FAS and AM by the CFTC. The action is still pending, and I am negotiating with the Commission concerning its disposition.

The Receiver's Research Activities

Numerous legal issues have arisen during the course of the Receivership which have required legal research. Various questions have arisen concerning responsibilities and duties of an equity receiver. These were examined. Legal questions have arisen under the CFTA concerning the Commission's ability to continue reparations proceedings when the entity that is subject to them is under common law receivership. These questions had to be researched. A controversial area under the CFTC is the existence and scope of private rights of action. I have made extensive inquiry into these areas, particularly as they may bear on claims available to me.

Activities of the Receiver's Accountants

As previously mentioned, an accounting firm was appointed, pursuant to Court Order, to prepare an accounting of certain aspects of the financial activities of FAS and AM. This has proved to be a highly complex task for several reasons. First of all, FAS and AM personnel, who under other circumstances might be available to respond to the many questions that arise about the nature of entries in the books and records of FAS, have been unavailable. Supporting documentation for many entries in the books and records of FAS and AM does not exist or, when it does, exists in incomplete form. Former FAS bookkeeping personnel have been persuaded to answer certain types of questions concerning the books and records of FAS and AM; they have declined to answer other types of questions. Understandably, the task of analyzing hundreds of transactions involving millions of dollars in a company where the principals were involved in serious dishonesty is a complex task.

Following its appointment by this Court, the accounting firm made an initial survey of the books and records of AM, which included an analysis of FAS and AM books of original entry. In addition to this analysis, they made an extensive review of expense and other accounts in an attempt to identify improper transactions. In addition to providing the analysis called for by the Court's Order, the firm has assisted me by identifying, documenting, and tracing, to the extent existing documentation permits, apparently improper transactions with which FAS and AM were involved. It is anticipated that my activities over the coming months will focus to a large extent on further investigation of the transactions isolated by the accountants.

Assets Located by the Equity Receiver

As previously mentioned, when I was appointed there were no assets on hand in any bank accounts maintained by or in the name of FAS, AM, or Arabatzis other than $9,991.89 belonging to FAS and held by the Chase Manhattan Bank. Possession of these sums was obtained by me. To this money was added $52,492.44 obtained by me from the sale of the gold bar and coins.

I ascertained that some $3,144 was held by Macro International for the account of AM. Possession of the funds was obtained by me in July, 1979. In connection with criminal proceedings, Arabatzis posted a cash bond of $10,000. On application to the Honorable Kevin T. Duffy, this sum was turned over to me. Most of the assets will be consumed by costs of administering the estates. Unless substantial additional ones are found, a distribution to investors is unlikely.

Based on my experiences as Receiver, I offer the following observations:

1. In situations such as the one I confronted where the principals of the company were criminals, perhaps no remedy (apart from stiff prison sentences) is likely to be an effective method of protecting public investors.

2. Where the company has been looted or where its funds have been diverted outside of the company, reparations proceedings are almost totally ineffectual remedies.

3. Without the active cooperation of one or more individuals who have run the business or who are knowledgeable about it, a receiver faces an enormously expensive and difficult job in attempting to understand how the business operated, what records were kept and by whom, what the records reflected, etc. This difficult reconstructive process is necessary for a basic understanding of how money was handled by the business, where it went, where it should have gone, and how it may have been taken out. I was unable to require former FAS or AM employees to cooperate, and voluntary cooperation was sporadic and frequently undependable.

4. In my opinion, the most serious impediment to an effective receivership proceeding (structured like mine) was that I was empowered to marshal only estate assets, not to pursue claims belonging to public investors. Cheated public investors may have substantial claims against individuals or entities such as the accountants or lawyers who assisted the company or the clearing brokers with whom the company dealt. Typically, such claims are not estate claims; and to the extent they may be, the entities exposed to the claims may have substantial defenses (e.g., pari delicto, no deception) to estate claims that are not available to claims by public investors. The correction of this weakness could enable the receiver to attempt, through class action-type litigation, to pursue claims that could present the prospect of substantial recovery for individual investors.

5. At the time I was appointed Receiver, the New York office of the CFTC was too thinly staffed to be of significant assistance. Even though the staff was completely cooperative, apparent staffing limitations, I believe, prevented substantial or significant assistance to me.

6. United States Postal Service investigators and Internal Revenue Service special agents had done high quality forensic accounting work on the books and records of FAS and AM. Because I was not a law enforcement agency and was appointed in a civil proceeding, they were not in a position to share their findings with me. As a result, I, with the assistance of my own accountants, had to attempt to redo analyses that I suspect parallel the work of the Postal Service and the I.R.S. and were probably not as good. Access to the findings of these agencies would have been of enormous help to me.

I hope the foregoing has been of some assistance to you and responsive to your request.

Very truly yours,

Barrington D. Parker, Jr.

bdp,jr:cg

EXHIBIT NO. 12--Continued

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United States Senate

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MARTY STEINBERG
CHIEF COUNSEL TO THE MINORITY

October 7, 1981

John K. Notz, Jr.
4600 One First National Plaza
Chicago, Illinois 60603

Dear Mr. Notz:

I have recently been made aware of the growing extent of fraudulent activity in the commodity futures industry. I obviously am concerned over this development, particularly in light of the relative infancy of the Commodity Futures Trading Commission and the sunset provision of the law authorizing its existence until 1982. Accordingly, I have asked the staff of the Permanent Subcommittee on Investigations to undertake a study of various unscrupulous practices now occurring in the commodities field, with an emphasis on off-exchange transactions.

I understand that you were appointed the receiver in a recent court action captioned CFTC v. Chicago Discount Commodity Brokers. In that action, the Commodity Futures Trading Commission obtained an injunction enjoining the defendants from continuing to operate in a manner designed to defraud the public.

One of the primary purposes of the Subcommittee's study is to determine the magnitude of these fraudulent operations by developing statistical data pertaining to receiverships. Hence, specifically, I would greatly appreciate responses to the following questions:

1. How many customers were defrauded by Chicago Discount Commodity Brokers?
2. What states are represented by these customers?
3. How much money did Chicago Discount Commodity Brokers receive from these customers during its period of operation and how much did it pay out to its customers?

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4. What was the average investment of each customer?
5. What was the average loss to each customer on his investment?
6. How much money has the receivership recovered? What problems, if any, has the receivership encountered in marshalling assets? For example, have the banks here and abroad been cooperative? Have court orders or other decrees provided sufficient authority to claim funds belonging to the customers?
8. What is the current status of the receivership? Have funds been distributed? If so, how much of a customer's investment has been regained, e.g., 10¢ on the dollar? expenses, etc?
9. What recommendations, legislative or otherwise, do you have relating to the operation of receiverships? It would assist us if you would include in your response consideration of the Commodity Exchange Act, the Bankruptcy Code, tax laws and any other legislation with which you may have come into contact in fulfilling your duties.

Thank you for your consideration in this matter. If you have any questions, please do not hesitate to contact Carolyn Herman, Staff Counsel, at 224-3721.

Very truly yours,

Bill Roth

William V. Roth, Jr.
Chairman

WVR,JR:chc

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October 2, 1981

Katherine McGrath
c/o John K. Notz, Jr.
4600 One First National Plaza
Chicago, Illinois 60603

RE: Chicago Discount Commodity Brokers Receivership

Dear Ms. McGrath:

Further reflecting on our conversation of last week, I would like to clarify certain aspects of Senator Roth's request in connection with the above matter.

Specifically, with respect to question #2, you need not provide us with the names of each state represented by Chicago Discount Commodity Brokers customers, but rather you need only indicate the number of states represented. Secondly, with respect to questions #3 - 7, should responding to these questions become unduly burdensome, you need not furnish us with the information except to the extent that you provide us with a general idea of (1) the average loss sustained, (2) profits realized, (3) amounts recovered, (4) amounts distributed and (5) expenses charged to the recievership. Lastly, I want to reiterate that our letter is intended solely as a public service request and that any expense incurred in answering such request is not to be charged to the receivership.

If you have any further questions, please do not hesitate to call me at (202) 224-3721.

Very truly yours,

Carolyn Herman
Staff Counsel

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EXHIBIT NO. 12--Continued

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COUNSEL

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December 1, 1981

Senator William V. Roth, Jr., Chairman
United States Senate
Committee on Governmental Affairs
Senate Permanent Subcommittee on Investigations
Washington, D.C. 20510

Dear Senator Roth:

I would like to preface my response to your Committee's inquiries regarding Lloyd, Carr & Co. by bringing you up to date on the status of the civil proceedings. In January, 1978, I was appointed Equity Receiver in the pending action commenced by the Commodities Future Trading Commission. Shortly after my appointment as Equity Receiver, involuntary petitions in bankruptcy were filed against Lloyd, Carr & Co. and Alan Abrahams a/k/a James Carr. Subsequently, I was appointed Receiver in Bankruptcy for the alleged bankrupts and am now serving as Trustee.

Lloyd, Carr, & Co. and Alan Abrahams were adjudicated bankrupts in December of 1980. During the administration of these estates, I have marshalled over six million dollars in assets and have instituted ancillary litigation to recover additional assets. There are currently approximately thirty million dollars in claims against the estates, over twenty million of which have been filed on behalf of the bankrupts' defrauded customers.

The parties in interest have, after months of negotiations, arrived at a universal settlement. The proposed compromise has been presented to the Court and approved. If the conditions precedent to the effectuation of the compromise are satisfied, the major portion of the estate assets will be distributed by the end of 1981.

To the best of my knowledge, the answers to your specific questions are as follows:

1. Lloyd, Carr & Co., James A. Carr and/or Charles P. Lemieux had approximately 3,900 customers.

2. The majority of the states were represented by the customers.

3. During the operation of the company, approximately twenty-seven million ($27,000,000) dollars was invested in Lloyd, Carr & Co. and approximately $150,000 was paid out to the customers either by way of refund or returns on investment.

4. The average investment was $6,300 to $6,400.

5. The average investor lost his total investment.

6. The Receiver/Trustee recovered over six million dollars which as been substantially increased through investment during the bankruptcy administration. Domestic banks were fairly cooperative, however, substantial bank resistance was encountered by the Receiver in Switzerland and Bermuda. Eventually, after litigation in Bermuda and the invocation of a Swiss-American treaty, approximately four million dollars was recovered from these jurisdictions. The Receiver/Trustee has initiated several ancillary actions to recover various other estate assets which include in part a motel and a residence. It appears that title to these contingent assets will only be resolved through further litigation.

8. I believe I have incorporated my response to this question in my introduction. The amounts designated under the compromise for settlement of the customers' claim will yield the non-gold option investors approximately ten cents on the dollar invested, and for the gold-option investors slightly more. These estimates are net amounts after deduction of expenses.

9. A final analysis of my recommendations is premature at this stage. When my administration is wound up, I will be pleased to supplement and amplify the following observations and suggestions.

At this juncture, I would make several comments. During my administration, I had to marshall a substantial amount of assets from foreign jurisdictions and from various states. As soon as it was ascertained that millions of dollars had been secreted in Switzerland, my counsel was in contact with the State Department. I was advised that a list of recommended Swiss counsel would be forthcoming. After waiting a number of weeks, I retained a former classmate of a firm member of my court-appointed counsel. The delay incurred could have cost the estate a substantial amount of assets. Fortunately my choice proved most capable and efficient. The State Department did, however, lend invaluable assistance regarding the first utilization of a Swiss-American treaty which eventually resulted in the transfer of the Swiss funds without formal litigation.

Ironically, removal of the bankrupts funds from Bermuda proved much more difficult, expensive and protracted. I was forced to undergo costly litigation and eventually was finally successful in recovering these funds but only by agreement. In fact, my litigating prognosis was less than optomistic. There were critical issues of title and right to possession which it was doubtful that I would win.

From my experience in these two foreign jurisidictions, it is apparent that a comprehensive study of foreign bankruptcy and other related law should be undertaken to help formulate and negotiate treaties and/or international agreements which would deal with these conflicts and which would effectuate the efficient transfer of a bankrupts funds in foreign jurisdictions.

Due to the criminal proceedings in the Federal Court against the individual bankrupt and his associates, there were multiple areas in which both my administration and the federal authorities had vested interests. Access to various records and other information was restricted. Vital information was either unavailable or delayed due to intra-agency overlap. Due to this communication problem, I am certain that valuable time may have been lost in locating and freezing assets.

I have had little contact with the Commodities Future Trading Commission during the bankruptcy administration. For the first few months of the equity receivership, the Commission did review the records of the bankrupts. I have no knowledge of the results or the existence of any investigation conducted by the Commodities Future Trading Commission. Shortly after my appointment, realizing that the defrauded customers were an unprotected class of potential creditors, I requested that the Court appoint a customer representative, a hybrid of the representative appointed in Chapter X cases.[1]

---

[1] It should be noted that the Bankruptcy Code has made very substantive changes and specific provisions in this regard. However, my administration is governed by the old Act and my comments must be evaluated in this regard.

My motion was allowed, and Gael Mahoney, Esquire, was appointed. The Customer Representative has diligently and very ably represented his clients' interests.

After almost four years of litigation and the probabilities of years of more, it appears that a universal settlement of all claims will be effectuated this calendar year. Reviewing the past events, the arduous and fervent negotiations which led up to the compromise and the participation of the parties in interest themselves, I believe that the true spirit and portent of the Bankruptcy Act have been fulfilled. Each party evaluated their risk and potential benefit with a careful view to the practical aspects of time and money and arrived at a realistic and viable compromise.

Please do not hesitate to call if I can be of further assistance.

Sincerely yours,

Walter H. McLaughlin Sr.

Walter H. McLaughlin, Sr.

WHM:djb

EXHIBIT NO. 12--Continued

JOHN K. NOTZ, JR.

December 18, 1981

The Honorable William V. Roth, Jr., Chairman
Senate Permanent Subcommittee on Investigations
Committee on Governmental Affairs
United States Senate
Washington, D. C. 20510

Dear Senator Roth:

This is intended to be responsive to your letter to me in my capacity as Interim Trustee for Chicago Discount Commodity Brokers, Inc., of October 7, 1981 (copy enclosed), as supplemented by the letter of Staff Counsel to Mrs. McGrath of Gardner, Carton & Douglas (my legal counsel) dated October 2 (sic), 1981 (copy enclosed).

I confirm the following advice Mrs. McGrath has given to your staff counsel:

(a) I have no reason to believe that any off-exchange trading transaction for the account of a public customer was effected by CDCB; and

(b) I was appointed Receiver for CDCB on October 27, 1980, and served as such from October 28, 1980. I was appointed Interim Trustee in United States Bankruptcy Court Case No. 80 B 14472 (U.S.B.C., N.D. Ill.) on November 4, 1980, and have since been acting as such.

With respect to your questions,

(1) Public Customer Profile. CDCB had about 510 public customers; precision in the count is difficult because of variations in account titles and the use of assumed names. Of the 510 customers, about 438 used U.S. addresses, in 42 states, and about 72 have non-U.S. addresses, 59 in Canada and 10 in Mexico.

(2) Average Loss: I estimate that approximately 425 customers will recover at least 55%-60% of their approved claims, being at least about 55¢-60¢ on each $1.00 of customer account "net equity". I anticipate that approved customer claims will aggregate about $10,500,000 and that I will liquidate assets for proceeds of about $6,000,000. This translates into losses of up to about 40%-45% of customer account net equity.

(3) Profits Realized - Since virtually all open account positions were liquidated as of October 27, 1980, the Estate has realized no profits from them. As assets have been recovered and liquidated, the proceeds have been invested and reinvested in short-term United States Treasury Bills, and interest therefrom, as earned, becomes an asset of the estate.

(4) Amounts Recovered - I have obtained proceeds of liquidation of assets aggregating approximately $5,200,000. Because of the difficulty of predicting the outcome of unresolved matters, I am not yet able to estimate confidently that proceeds of the liquidation process will exceed about $6,000,000.

(5) Amounts Distributed - On May 1, 1981, within six months after the initiation of the bankruptcy proceeding, a 40% First Interim Distribution was commenced to claimants having approved claims. A 7% Second Interim Distribution is about to be proposed. Another such 7%-13% Third Interim Distribution presently appears to be feasible soon. Further distributions, if any, are contingent upon the resolution favorable to the Estate of the unresolved matters referred to above.

(6) Expenses of the Receivership - I have asked that I be authorized to pay the minor expenses of the receivership - aggregating less than $5,000 - out of the bankruptcy estate. This request is pending before the Bankruptcy Judge. Incurred through October 31, 1981, but not yet paid, were expenses aggregating approximately $225,000, virtually all of which is still subject to the approval of the Bankruptcy Court. I cannot presently estimate the aggregate amount of expenses that the Estate will incur.

(7) Marshalling of Assets - I have no reason to believe that "banks abroad" were involved in the affairs of CDCB in any substantial manner. As for U.S. financial institutions, each has protected its customers' interests. Available legal process, subject to inherent delays, has been adequate.

(8) Recommendations -

(a) An equity receivership, in the light of the existence of provisions in the Bankruptcy Code for liquidation of a futures commissions merchant ("FCM") such as CDCB, is not a suitable means of dealing with an insolvent FCM. As a result, I caused to be prepared and filed an appropriate petition permitted by the Bankruptcy Code. My authority to do this was questioned by one of the principals of CDCB in a manner that caused substantial confusion among the public customers of CDCB and, as a result, unnecessary delays. I urge that the Bankruptcy Code be amended to provide in more specific language that a duly appointed receiver has the authority to cause a bankruptcy petition to be filed.

(b) The specific identification of securities or other property concept provided for in Bankruptcy Code §766 operates, I believe, to the detriment of the Estate and of customers, generally. On November 19, 1981, the Commodity Futures Trading Commission proposed regulations that, if adopted, should eliminate this problem as it is created by specifically identifiable property other than securities.

(c) I also urge that Section 766 be amended to provide in substance that (i) all securities or other property of customers shall, for computation of claims purposes, be marked to the market as of the close of trading on the date of the commencement of the case; (ii) the trustee may reduce to money, consistent with good market practice, all such securities and other property as soon as practicable after the commencement of the case; (iii) the trustee may use funds, securities or other property of customers, generally, as margin for such hedging positions as he deems appropriate for the orderly reduction to money of such securities and other property; and (iv) all reasonable expenses incurred by the trustee in so doing shall be paid out of the proceeds of liquidation of customer property.

(d) A substantial creditor/customer of CDCB sought on January 22, 1980, to replace me. Many questions arising out of the election process are still at issue in the courts, and I do not believe that I should comment on them. However, many of those questions could have been avoided if the Bankruptcy Code were amended to provide detailed rules relating to such things as (i) timing of the election; (ii) voting rights of customers; (iii) notice provisons; and (iv) proxies.

(e) With respect to Bankruptcy Code §764, as the application thereof to customers of any FCM in liquidation in bankruptcy is the subject of pending proceedings in the Bankruptcy Court, I am not making a recommendation herein with respect thereto.

(f) In general, I believe that the CFTC performs an essential function with respect to our nation's commodities markets, that that function must be performed by a Federal agency, and that industry pressures on self-regulatory organizations would be such that no self-regulatory organization, alone, would be able to protect the public interest in efficient, fair, open and liquid commodities markets.

Respectfully submitted,

John K. Notz, Jr.

John K. Notz, Jr.
Interim Trustee
4600 One First National Plaza
Chicago, Illinois 60603
Direct Line: (312) 845-9209

JKN/jdc
CC: Mrs. Kathryn McGrath
Gardner, Carton & Douglas, D.C.

EXHIBIT NO. 13

DUN & BRADSTREET INTERNATIONAL

1-39389 FN

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PLEASE NOTE WHETHER NAME, BUSINESS AND STREET ADDRESS CORRESPOND WITH YOUR INQUIRY.

JULY 31, 1979
COMERCIAL PETROLERA INTERNACIONAL PANAMA
CABLE CONFIRMATION

INFORMATION RECEIVED BY CABLE ON THE ABOVE DATE DISCLOSED THE FOLLOWING:

CHARTERED JUNE 1979
SUCCEEDING COMPANIA DEL GOLFO PERSICO
CHARTERED JULY 1974 WORTH 15,117,000
TRADERS IN CRUDE PETROLEAM OIL
JAIME PADILLA PRESIDENT MANAGER

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PERSIAN GULF COMPANY INC.
(INCORPORATED IN PANAMA)

HAFEZ AVENUE No. 284
TELEPHONE 83-4031
EXT. 15 & 18

POSTAL ADDRESS
P. O. BOX 1466
TEHRAN, IRAN
TLX: 212598 IPAC IR

LAST BALANCE OF THE COMPANY
BEFORE THE IRANIAN REVOLUTION

OWSIA PARVIZ

Authorized Public Accountant
84 West
Tahkte Jamshid Ave.
Tehran - Iran

PERSIAN GULF COMPANY INC.

AUDITOR'S GENERAL REPORT

1978

OWSIA PARVIZ

Authorized Public Accountant
84 West
Tahkte Jamshid Ave.
Tehran - Iran

BALANCE SHEET 1978

ASSETS		
Cash on hand and balances with banks and Financial Companies	US$ 9,876,443.00	
Time deposits	3,467,243.00	
Standby credit	12,000,000.00	
Sundry debitors	600,000.00	
Holdings in subsidiaries and associated companies	11,000,221.00	
Fixed Assets	650,000.00	
TOTAL OF ASSETS		37,593,907.00
LIABILITIES		
Banks and financial Institutions-fixed term borrowing	2,500,229.00	
Adjustments accounts	900,000.00	
Sundry creditors	97,000.00	
Provision for investment	750,000.00	
TOTAL OF LIABILITIES		4,247,229.00
CAPITAL		
Issued capital	10,000,000.00	
Reserves	2,000,000.00	
Unappropriated profit	1,447,000.00	
Current year's profit	1,670,000.00	
TOTAL OF CAPITAL		15,117,000.00
TOTAL OF LIABILITIES AND CAPITAL		US$ 19,364,229.00

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Dun & Bradstreet International Report

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2.

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BLOCK REPORT JULY 31, 1979

COMERCIAL PETROLERA INTERNACIONAL, S.A.

EDIFICIO GUSROMARES
AVE. BALBOA & AVE. FEDERICO BOYD
P.O. BOX 4019
PANAMA CITY
PANAMA
PHONE: 69-2417

OFFICERS/DIRECTORS
JAIME RICARDO ARIAS, PRESIDENT
JAIME PADILLA BELIZ, SECRETARY/TREASURER
JAIME PADILLA GONZALEZ
ALFONSO GUTIERREZ

Subject is a corporation originally chartered under the laws of Panama on July 12, 1974 as COMPANIA DEL GOLFO PERSICO, S.A. The present corporate style was adopted on June 7, 1979. Authorized capital 10,000,000, divided into 1,000 bearer of shares of 10,000 each. The major shareholder is reported to be one John P. Pochna who maintains registered domiciles in Montecarlo, Ireland and England. Term of corporate duration indefinite.

Jaime Ricardo Arias, of legal age, married. Lawyer by profession. Connected with the law firm ABOGADOS PANAMENOS INC.

Jaime Padilla Beliz, of legal age, married. Has a bachelor degree in Applied Psychology from Pennsylvania State University.

Jaime Padilla Gonzalez, of legal age, single. Son of the president. Lawyer by profession.

Alfonso Gutierrez, born on December 24, 1935, married. Has a degree in Civil Engineering from the University of Caracas.

The firm under review was originally registered to engage in the purchase and sale of crude oil and, for this purpose, maintain its operating headquarters at Hafez Avenue No. 284, Tehran, Iran. However, as an result of the recent political development in that country subject was forced to close down its operations there. As of May 28, 1979 the firm has been engaged in the sale of crude oil futures. At caption address subject maintains a contact office for the handling of correspondences. It is not known locally as a seeker of commercial credit.

CURRENCY: Monetary amounts are in local currency unless otherwise specified.

6/17/79 (800-22-13-7).

[redacted]

Grand Jury
Exhibit No. 55B
11/18/80 ce

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EXHIBIT NO. 14

ADVERTISEMENTS FOR COMMODITY TELEPHONE SALESMEN

Miami Herald 4/13/80

Telephone Sales

COAL

New Energy Program

Tired of the same old script? "Here today, Gone Tomorrow"

An experienced well-organized group of business men has commenced the operation of an exciting new entity, Dealing in the sale of coal.

ESTABLISHED SALES AGENCIES to be considered to market this product.

AGENCIES ONLY

NATIONAL COAL EXCHANGE

To make app't., call Reg. Sales Mgr. Mr. Kercheff: 595-9432

Miami Herald 2/1/81

$100,000

SALESMEN DID YOU MAKE $100,000 LAST YEAR? IF YOU DID NOT AND YOU ARE CONFIDENT YOU COULD HAVE WITH THE RIGHT TRAINING; WRITE-IN LEADS, SUPERVISION AND WORKING ENVIRONMENT. GIVE US A CALL, WE DEVELOP WINNERS. ALL CALLS HELD IN CONFIDENCE.

ELLIS KAHN OR TOM THURMAN

COMMODITIES INTERNATIONAL CORP.

865-0311

Miami Herald 4/12/81

SALES

CAN YOU MEET YOUR OBLIGATIONS ON $15,000 COMMISSION PER YEAR

Excellent qualified leads. Excellent new selling concept. Numerous company benefits for the highly motivated experienced professionals. Hospitalization, Dental & Life Insurance.

UNIVERSAL PRECIOUS METALS INC.

2755 E. Oakland Pk. Blvd., Suite 301
Ft. Lauderdale, Fla.
Call Pat 563-3553

Miami Herald 7/12/81

IF YOU DID NOT MAKE $100,000 LAST YEAR YOU'RE WORKING FOR THE WRONG FIRM

Roan & Rutledge Defense Metals, a subdivision of Atwood & James Petroleum is now selling strategic metals. We are offering the highest commission in town on strategic metals & best lead sources.

If you have ever sold oil, commodities, gold, silver, chemicals, real estate, finance, you owe it to yourself to come up & see what this dynamic new business is all about.

Please call Dennis Goddard at

573-0252 or 573-5619

EXHIBIT NO. 15

UNITED STATES OF AMERICA
COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W.
Washington, D.C. 20581

NOTICE

Due to the large number of claims now pending in the reparations process, delays in a final adjudication on the merits may be as long as two years. In determining whether or not to file a reparations complaint with the Commission you should consider alternative methods of redress which may include arbitration or the filing of a civil action in either state or federal court.

EXHIBIT NO. 16

200

11¢ 1'
19

1-125
11-20-77

S U G A R D R I V E

HELLO MR.__________. THIS IS MR.__________WITH [redacted] CONDON COMMODITY OPTIONS? HOW ARE YOU THIS EVENING? HAVE YOU RECEIVED THAT INFORMATION I MAILED YOU? [redacted] FINE

NOW YOU CAN SEE WHY WE'RE SO EXCITED ABOUT SUGAR. WE FEEL IT'S AT IT'S BOTTOM, IT'S UNDERPRICED, AND IT'S ABOUT TO MAKE IT'S UPWARD MOVE.

AS YOU KNOW, AFTER READING THE REPORT, SUGAR IS SELLING BETWEEN 4¢ AND 6¢ A POUND LESS THAN IT COSTS TO PRODUCE. AS THE NEW YORK TIMES POINTS OUT, "VERY FEW PRODUCERS IN THE NON-COMMUNIST WORLD CAN PRODUCE SUGAR AT THESE PRICES AND STAY IN BUSINESS." FARMERS ARE LOSING A GREAT DEAL OF MONEY BY PRODUCING SUGAR, SO IT IS ONLY LOGICAL THAT THEY REDUCE PLANTINGS IN 1977. NOW JUST LAST WK. SEC OF AGRICULTURE BERGLAND ANNOUNCED PENDING PRICE SUPPORTS OF 14-15¢ A LB. WHICH MEANS IN ALL PROBABILITY SUGAR SHOULD MOVE UP TO AT LEAST 1-15¢ to NOW MR.________WE ARE TALKING ABOUT AN OPTION THAT RUNS TO MAY 78. WHICH GIVES YOU A LONG TIME IN THE MARKET WITHOUT HAVING TO WORRY ABOUT COMING UP WITH ADDITIONAL FUNDS IN THE FORM OF MARGIN CALLS. [redacted]. ARE YOU FAMILIAR WITH MARGIN CALLS? FINE. YOUR TOTAL RISK IS LIMITED TO THE PRICE OF THE OPTION. WE'RE TALKING ABOUT A $_______INVESTMENT, AND IN SUGAR EACH PENNY IS WORTH $1120, SO IF SUGAR ONLY MOVES 3½¢ YOU'VE GOT YOUR ENTIRE INVESTMENT RETURNED. IF SUGAR MOVES 7¢ YOU'VE DOUBLED YOUR INVESTMENT. IN OTHER WORDS, IF SUGAR MOVES TO WHERE FARMERS DO LITTLE MORE THAN BREAK EVEN, YOU DOUBLE YOUR MONEY. DO YOU FOLLOW? →

IN ADDITION, THIS YEAR THE WORLD HAS SUFFERED GREAT DROUGHTS. IN EUROPE, THEY WERE HIT WITH THE WORST DROUGHT IN CENTURIES, AND OVER 30% OF THE SUGAR BEET CROP HAS BEEN DESTROYED. CUBA ALSO WAS HIT BY DROUGHT AND SUFFERED SEVERE CROP DAMAGE.

ALSO TO ADD FUEL TO THE FIRE, ~~JUST THE OTHER DAY ON TV~~, THERE ~~WAS~~ ARE ~~AN~~ REPORTS OF A SUGAR BLIGHT CALLED SUGAR SMUT, THAT IS DESTROYING THE SUGAR CROPS OF JAMAICA, BERMUDA, AND TRINIDAD. AGRICULTURISTS FEAR THAT THE TRADE WINDS MAY CARRY THIS DISEASE ACROSS THE CARRIBBEAN TO CUBA AND THE UNITED STATES. IF THIS SHOULD HAPPEN, WE COULD POSSIBLY SEE A RERUN OF 1974, IN WHICH SUGAR WENT FROM 11¢ TO 68¢ A POUND IN 6 MONTHS, AND AS YOU KNOW, IN SUGAR EACH PENNY IS WORTH $1120 DOLLARS.

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SO MR.________, IF IT'S NOT GOING TO CHANGE YOUR LIFESTYLE OR TAKE BREAD OFF YOUR TABLE, DO YOURSELF A FAVOR, AND GET IN NOW WHILE SUGAR IS AT A VERY LOW LEVEL. POSSIBLY THIS COULD BE THE BEST ________INVESTMENT YOU'VE MADE. FAIR ENOUGH? (GO TO CLOSE)

FIRST REBUTTAL ✓

MR.________, I WANT TO SEE YOU GET INVOLVED NOW, WHILE SUGAR IS SO LOW PRICED, SO THAT WE CAN MAXIMIZE YOUR PROFITS IN SUGAR. BELIEVE ME I WANT TO BE ABLE TO REINVEST SOME OF THE PROFITS FROM SUGAR LATER ON INTO WHATEVER OUR RESEARCH TEAM SAYS IS MOVING THEN. LET'S FACE IT, ONE SHOT BUSINESS MAKES NO SENSE TO ME, AND IT SHOULDN'T MAKE SENSE TO YOU EITHER. IF I CAN'T BUILD THIS UP TO A 40,000 TO A 50,000 THOUSAND DOLLAR A YEAR ACCOUNT FOR YOU IT'S NOT WORTH IT TO ME OR TO YOU. AM I RIGHT? (GO TO CLOSE)

SECOND REBUTTAL

MR.________, IN ADDITON TO EVERYTHING I HAVE TOLD YOU, THERE IS ALSO A GOOD POSSIBLILITY THAT THE MAJOR PRODUCERS OF SUGAR THROUGHOUT THE WORLD WILL FORM A CARTEL TO FORCE THE PRICE OF SUGAR UP. YOU KNOW WHAT THE ARABS AND OPEC HAVE DONE TO THE PRICE OF OIL. THERE IS NO REASON TO DOUBT THAT A SUGAR CARTEL WOULD NOT ALSO BE SUCCESSFUL IN DRIVING THE PRICE OF SUGAR UP.

SO, IN SUMMARY MR.__________, YOU HAVE AN EXPLOSIVE SUPPLY/DEMAND PICTURE, WITH CONSTRICTING SUPPLY AND EXPANDING DEMAND...YOU HAVE SUGAR PRICES AT THE LOWEST POINT IN YEARS...YOU HAVE THE PRICE OF YOUR INVESTMENT AT A VERY LOW LEVEL...AND YOU HAVE ENORMOUS PROFIT POTENTIAL, FOR IF SUGAR MOVES UP ONLY 15¢ YOU HAVE A RETURN OF CLOSE TO $17,000. IS THAT FAIR ENOUGH? (GO TO CLOSE)

CLOSE

GET A PENCIL AND PAPER AND I'LL SHOW YOU WHAT TO DO...

COPY THIS DOWN.............BANKERS TRUST CO.
CUSTOMER RECEIPTS # 051-41-668-445
1 WHITEHALL STREET
NEW YORK, NEW YORK 10004

REPEAT THAT BACK.

NOW GO TO YOUR BANK THE FIRST THING IN THE MORNING AND WIRE TRANSFER THE __________FROM YOUR BANK TO THE BANKERS TRUST COMPANY.

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NOW AS LONG AS I CAN COUNT ON YOU GETTING THAT WIRE OFF TO NEW YORK IN THE MORNING, I'LL CALL NEW YORK TONIGHT AND PLACE AN OPEN ORDER FOR YOU, PROTECTING YOU AT THE PRICE OF_______PER OPTION. HOW MANY OPTIONS CAN YOU HANDLE AT THIS TIME? FINE.

NOW CAN I COUNT ON YOU HANDLING THAT THE FIRST THING IN THE MORNING, BECAUSE THIS MARKET CLOSES AT 12 NOON NEW YORK TIME?

NOW AS SOON AS THE WIRE COMES THROUGH YOUR ORDER WILL BE EXECUTED AT THE LOWEST PRICE POSSIBLE. WITHIN A FEW DAYS YOU WILL RECEIVE A CONFIRMATION NOTICE, WITH YOUR STRIKING PRICE ALONG WITH A REGISTRATION NUMBER, SHOWING THAT YOUR OPTION IS REGISTERED. FAIR ENOUGH?

O.K. NOW IF YOU HAVE ANY DOUBT ABOUT GETTING THAT WIRE OFF IN THE MORNING, LET ME KNOW, SO I DON'T STICK MY NECK OUT AND PLACE THAT OPEN ORDER.

DO YOU HAVE ANY DOUBT?

O.K. FINE.

MR. _________, I AM SURE THIS IS THE BEGINNING OF A LONG AND PROSPEROUS RELATIONSHIP. IF YOU EVER HAVE ANY QUESTIONS AT ALL, PLEASE DON'T HESITATE TO CALL ME PERSON TO PERSON COLLECT.

HAVE A NICE EVENING.

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3rd REBUTAL

MAYBE YOU DON'T UNDERSTAND FULLY THE WAY THE OPTION WORKS. COMMODITY OPTIONS GIVES YOU THE SAME HIGH LEVERAGE AND ENORMOUS PROFIT POTENTIAL THAT YOU GET IN THE COMMODITY FUTURES MARKET, BUT AT THE SAME TIME GIVES YOU PROTECTION AGAINST THE TWO BIGGEST DRAWBACKSOF THE FUTURES MARKET; MARGIN CALLS AND FORCED LIQUIDATION. BY THAT I MEAN, IN THE FUTURES MARKET, IF THE MARKET GOES DOWN, EVERYTIME IT GOES DOWN YOU HAVE TO COME UP WITH ADDITIONAL CASH IN THE FORM OF MARGIN. IF YOU EITHER DON'T CARE TO OR CAN'T AFFORD TO COME UP WITH THE ADDITIONAL CASH YOU ARE LIQUIDATED BY YOUR BROKER--- SQUEEZED OUT OR SCARED OUT OF THE MARKET, AND YOU LOSE EVERYTHING YOU'VE INVESTED. THEN SAY THE MARKET REBOUNDS IN A FEW MONTHS AND GOES THROUGH THE ROOF, AS THEY SO OFTEN DO, YOU DO NOT PARTICIPATE IN THE PROFITS, BECAUSE YOU WERE SQUEEZED OUT OF THE MARKET. ----- OR WORSE YET, SAY THE MARKET GOES DOWN AND YOU TRY TO LIQUIDATE OR SELL OUT, BUT NOBODY'S BUYING, (Limit Down) THEN YOU HAVE TO KEEP COMING UP WITH MARGIN UNTIL YOU'VE EITHER WIPED OUT FINANCIALLY OR THE MARKET REBOUNDS. IN EITHER CASE ITS A VERY UNEASY FEELING, AND IN THE MAJOR REASON PEOPLE SHY AWAY FROM COMMODITIES.

ON THE OTHER HAND, COMMODITY OPTIONS GIVES YOU THE PEACE OF MIND OF A LIMITED PREDETERMINED RISK ON THE DOWN SIDE OF THE MARKET. YOUR TOTAL FINANCIAL LIABILITY WOULD NEVER EXCEED YOUR ORIGINAL PURCHASE PRICE OF THE OPTIONS.

ALSO IF THE MARKET STARTED GOING DOWN YOU HAVE NO MARGIN CALLS TO WORRY ABOUT BEING LIQUIDATED BY YOUR BROKER ---- YOU JUST HOLD ON TO YOUR OPTION AND WAIT FOR THE MARKET TO REBOUND BACK TO THE PROFIT SIDE BEFORE THE TERMINATION DATE ON YOUR OPTION. IN OTHER WORDS YOU HAVE TIME WORKING ON YOUR SIDE. IN ADDITION YOU CAN EXERCISE YOUR OPTION AND TAKE YOUR PROFITS AT ANYTIME, IT IS NOT NECESSARY TO HOLD THE OPTION TILL ITS TERMINATION.---- NOW DOES THAT MAKE SENSE TO YOU OK?

1. GET A PENCIL AND PAPER AND I'LL SHOW YOU WHAT TO DO.
2. NOW CAN I COUNT ON YOU GETTING THAT WIRE OFF THE FIRST THING IN THE MORNING,

MR. ________, DO THE FACTS MAKE SENSE TO YOU? WELL, LET ME ASK YOU THIS, CAN YOU HANDLE $____________ AT THIS TIME? THEN WHY DO YOU HESITATE? ARE YOU INTERESTED IN MAKING MONEY?

CREDITABILITY

NOW MR. ______ I HAVE GIVEN YOU THE FACTS, I'VE SHOWN YOU THE TREMENDOUS POSITION YOU'RE IN TO MAKE SOME SERIOUS MONEY (I'M TALKING ABOUT A POSSIBLE RETURN OF $______.) NOW IF THE ONLY THING STANDING BETWEEN YOU AND I DOING SOME BUSINESS TOGETHER IS THE CREDITABILITY OF MY FIRM --DO YOURSELF A FAVOR, PUT YOUR MIND AT EASE AND CALL OUR REFERENCES THE FIRST THING IN THE MORNING. CALL THE BETTER BUSINESS BUREAU, CALL DUN AND BRAD, CALL THE BANKERS TRUST, NOW IF EVERYTHING CHECKS OUT TO YOUR SATISFACTION IN THE MORNING, CAN I COUNT ON YOU GETTING THAT WIRE OFF? (THAT CHECK OFF) FINE. NOW IN THE MEANTIME I'LL PLACE THAT OPEN ORDER TONIGHT PROTECTING YOU AT THE PRICE OF $______ PER OPTION, BASED ON THE CONTINGENCY OF OUR REFERENCES CHECKING OUT. I KNOW OUR CREDITABILITY WILL CHECK OUT, SO THERE IS NO PROBLEM THERE. NOW IS THAT FAIR ENOUGH?

WIFE OBJECTION

NOW MR. _____ I HAVE GIVEN YOU THE FACTS, I'VE SHOWN YOU THE TREMENDOUS POSITION YOU'RE IN TO MAKE SOME SERIOUS MONEY (I'M TALKING ABOUT A POSSIBLE RETURN OF $______.) NOW IF THE ONLY THING STANDING BETWEEN YOU AND I DOING SOME BUSINESS TOGETHER IS YOUR WIFE, THEN PUT HER ON THE PHONE. I'M SURE SHE HAS NOTHING AGAINST MAKING MONEY,AND ONCE SHE UNDERSTANDS FULLY THIS SITUATION, SHE MOST LIKELY WILL GO ALONG WITH YOUR DECISION. AM I RIGHT? FINE. PUT HER ON THE PHONE!

(SHE'S NOT HOME, WON'T COME TO THE PHONE ETC.)

WELL MR. ______ YOU'VE PROVIDED FOR YOUR WIFE, AND TAKEN CARE OF HER SUCCESSFULLY ALL YOU MARRIED LIFE, HAVEN'T YOU? SHE'S TRUSTED YOUR DECISSIONS BEFORE, HASN'T SHE?, WHY WOULD SHE NOT TRUST YOUR JUDGEMENT NOW? I'M SURE SHE WOULD! DON'T YOU AGREE? SO GET THAT WIRE OFF IN THE MORNING AND LET ME START MAKING SOME MONEY FOR YOU. GIVE ME 1% OF YOUR CONFIDENCE NOW, AND I'LL EARN THE OTHER 99% THRU SUCCESS. FAIR ENOUGH?

BEST AVAILABLE COPY

BANKER OBJECTION

MR. _______ I'M SURE YOU HAVE FAITH AND TRUST IN YOUR BANKER, BUT WHEN WAS THE LAST TIME HE CALLED YOU UP WITH AN OPPORTUNITY LIKE THIS. YOU KNOW ITS REALLY UNFAIR OF YOU TO ASK YOUR BANKER TO MAKE A DECISSION FOR YOU, AFTER ALL , HE PROBABLY KNOWS NOTHING ABOUT COMMODITY OPTIONS, AND LESS ABOUT (SUGAR COCOA ETC) AM I RIGHT? LET'S FACE IT HE KNOWS THE BANKING BUSINESS, WE KNOW THE COMMODITY BUSINESS. IF YOU ASKED ME A BANKING QUESTION, I'D PROBABLY BE LOST. IN ADDITION MR._______ HE HAS ABSOLUTELY NOTHING TO GAIN, AND EVERYTHING TO LOSE IN A SITUATION LIKE THAT. IF HE ADVISES YOU TO GET INTO THE MARKET, AND YOU ARE SUCCESSFUL, YOU GET ALL THE MONEY, NOT HIM. ON THE OTHER HAND IF THE MARKET WERE TO GO BAD, AND YOU LOST YOUR MONEY, HE'D DOOK BAD AND HE REALIZES THIS, SO HE'LL JUST ADVISE YOU AGAINST GOING INTO THE MARKET. ALSO, YOU PROBABLY HAVE TO TAKE MONEY OUT OF HIS BANK TO MAKE THE INVESTMENT. MONEY ON WHICH HE PAYS YOU 6%, AND THEN TURNS AROUND AND REINVESTS AT 20% to 25%. SO IN ESSENCE HE WOULD BE TAKING MONEY OUT OF HIS OWN POCKET. SO IT WOULDN'T MAKE SENSE FOR HIM TO ADVISE YOU TO GET INVOLVED, NO MATTER HOW GOOD THE INVESTMENT. DO YOU FOLLOW? SO GET THAT WIRE OFF TO ME IN THE MORNING AND LETS START MAKING SOME SERIOUS MONEY TOGETHER. GIVE ME 1% OF YOUR CONFIDENCE NOW, AND I'LL EARN THE OTHER 99% THRU SUCCESS. FAIR ENOUGH?

BROKER OBJECTION

MR. ______, I'M SURE YOU HAVE FAITH AND TRUST IN YOUR BROKER, BUT WHEN WAS THE LAST TIME HE CALLED YOU UP WITH AN OPPORTUNITY LIKE THIS. OR BETTER YET, HOW MUCH MONEY HAS HE MADE FOR YOU RECENTLY? LET'S BE FAIR TO EACH OTHER. ASKING YOUR BROKER ABOUT COMMODITY OPTIONS IS LIKE GOING INTO A FORD DEALER AND ASKING HIM, IF YOU SHOULD BUY A CHEVY. WHAT DO YOU THINK HIS ANSWER WILL BE. YOUR BROKER WILL PROBABLY TRY TO SELL YOU A FUTURES CONTRACT SINCE HE DOESN'T SELL OPTIONS, AND IF YOU WANT TO GAMBLE LIKE THAT, YOU'RE BETTER OFF IN LOS VEGAS, IF YOU KNOW WHAT I MEAN? (HA HA)

SO GET THAT WIRE OFF TO ME IN THE MORNING AND LET'S START MAKING SOME SERIOUS MONEY TOGETHER. I'M TALKING ABOUT A POSSIBLE RETURN OF $_______. IS THAT FAIR ENOUGH?

BEST AVAILABLE COPY

EXHIBIT NO. 16--Continued

FIRST CALLS TO QUALIFY

Good morning/afternoon Mr. ______________. How are you? My name is _____________. I'm in the Gold department with Metals Depository Corp. in New York. (FIRST NAME) I know you're busy, but this will only take a moment --- are you aware of what's happening to the price of Gold lately? (SHUT-UP AND LISTEN)

If asked --- (up from $165,00 to $________ per ounce and expected to reach 350 to 400 dollars per ounce within six months.) Our research department is putting together a Gold information report that will show you a gross profit of ______ to _______ thousand dollars on an investment of only __________thousand within a six month period. What do you think of this kind of profit? (SHUT-UP AND LISTEN) Fine, I'll get a package out to you and call you back in about a week to see how you like it. Would you prefer I send it to your home or your business? (VERIFY ADDRESS, ZIP CODE, CHECK SPELLING) What's the best time to reach you?

Incidentally ___(FIRST NAME)_____, if you like what you read, and this kind of profit return, are you prepared to invest _________? (SHUT-UP AND LISTEN) Fine, study the package carefully when it arrives, jot down any questions and we'll discuss them next week - alright. Bye!

IF ANSWER IS YES TO ALL THESE QUESTIONS, YOU NOW HAVE A QUALIFIED FIRST CALL.

REQUIRED CLOSE

--WITH ENTHUSIASM--

Hello can I speak to Mr. __________. Hello Mr. __________ this is SALESMEN'S NAME from Metals Depository Corporation. How are you today FIRST NAME? (AD LIB - WEATHER, SPORTS, BUSINESS--GET ACQUAINTED FOR NO MORE THAN A MINUTE.) Have you received the Gold Report that I personally sent to you? (WHEN HE SAYS YES, SAY "GREAT"!). (ASSUME THAT HE READ AND LIKED IT).

I'm sure you are interested in an investment that will keep you well ahead of inflation-RIGHT! (WAIT FOR AN ANSWER) and you must be aware of what's happened to gold since we last spoke. (WAIT FOR AN ANSWER AND REGARDLESS OF ANSWER GIVE HIM INFORMATION FAVORABLE TO A CLOSE.)

You must agree with me, FIRST NAME, that your dollar is not worth the same it was six months ago and will not be worth what it is today in months from now. You do agree with this, RIGHT? (WAIT FOR AN ANSWER).

With the GREAT opportunity our investment program offers you can expect a return of 50-200 percent on your investment dollar within six months. To show you how it works, everytime gold moves $1.00 you make a minimum of $100; we expect gold to reach 320-350 dollars an ounce early next year. That means that on an investment of 5100 you can expect a return of 10-13,000 dollars. Now that's the kind of money you want to make. Right! (WAIT FOR AN ANSWER).

Why not transfer from you account that's paying you 7-12% per year, to our account that's paying approximately 50-200 within six months?

We are advising our clients to invest in a 300 ounce plan for 14,700 dollars. However, you can get started in a 100 ounce plan for as little as 5,100 dollars.

Do you have a paper and pencil handy so I can give you the information necessary to open your account. These are our WIRING INSTRUCTIONS:

Barclay Bank
9 West 57 Street
New York, N.Y. 10022
Branch # - 056
Acc't # - 70708-8
Attention Current Accounts and made out to:

Metals Depository Corporation

If mailed - 880 Third Avenue
New York, NY 10002
Attention: Operations Department

By the way, now FIRST NAME would you prefer the 300 ounce or more Plan or the small 100 ounce plan - (WAIT FOR AN ANSWER).

IF YES - go either mail, Federal Express or Wires.

IF NO - isolate the objection, answer fully and ask for the money again.

EXHIBIT NO. 17

BORAKS & LECKAR
2000 L STREET, N.W.
SUITE 200
WASHINGTON, D.C. 20036
(202) 785-3240

ROBERT A. W. BORAKS
STEPHEN C. LECKAR*

*ALSO ADMITTED ILL. & GA. BARS

[illegible] NORTH LASALLE STREET
SUITE [illegible]
CHICAGO, ILLINOIS [illegible]
[illegible]

PLEASE REPLY TO:
Washington, D.C.

February 22, 1982

S. Cass Weiland, Esquire
Chief Counsel
Senate Permanent Subcommittee on
  Investigations
United States Senate
Washington, D.C. 20510

Re: Terry Ziegler, James Greenbaum, et al.

Dear Mr. Weiland:

Please forgive the delay in replying to your December 23, 1981 letter concerning the desire of the Permanent Subcommittee on Investigations to discuss certain matters with my clients, referenced above.

As I represented to you, because of the pendency of a grand jury investigation involving my clients, they must decline your invitation absent a grant of testimonial immunity.

Thank you for your attention.

Sincerely,
Bob Boraks
Robert A.W. Boraks

RAWB/mab

EXHIBIT NO. 18

COMMODITY FUTURES TRADING COMMISSION
2033 K STREET, N.W., WASHINGTON, D.C. 20581

OFFICE OF
THE EXECUTIVE DIRECTOR

MEMORANDUM FOR: The Commission

FROM: Donald L. Tendick
Executive Director

SUBJECT: Resources to the Options Pilot Program

At a meeting now scheduled for Tuesday, June 2, the Commission will be considering a proposal on exchange-traded options regulations. As part of that consideration, the Commission should keep in mind the question of priorities and resources. Presently, it is not possible to estimate the resource needs for options as the full scope of the program has not been clearly established. In view of the fact that the Commission's personnel ceiling for fiscal year 1982 has been reduced by 40 positions to 470 full-time permanent positions, present ongoing activities will have to be curtailed in order to absorb this decrease in personnel. In addition, if the Commission approves an options program, further curtailment of ongoing programs will be necessary. Also, the fiscal year 1982 resource projections did not include estimates for the Commission to regulate leverage and dealer option transactions.

While the question of resources will not be resolved at the June 2 meeting, it must be considered by the Commission and decided upon by the Commission prior to the adoption of any final regulatory package for exchange-traded options. This question is also important when by law we must present documentation of our ability to regulate options to Congress.

Files on earlier staffing projections are available if anyone desires to review them.

EXHIBIT NO. 19

COMMODITY FUTURES TRADING COMMISSION
2033 K Street, N.W., Washington, D.C. 20581

James M. Stone
Commissioner

February 23, 1982

Honorable Richard G. Lugar
Chairman
Subcommittee on Agricultural Research and General Legislation
Committee on Agriculture, Nutrition, and Forestry
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In connection with its 1982 reauthorization hearings, the Commodity Futures Trading Commission has recently submitted to the Congress a proposal seeking a number of amendments to its enabling legislation. 1/ The major elements of the Commission's proposal, a product of extensive work and deliberation, are highly constructive and worthy of your support. During my term as Commission Chairman and member, however, I have come to believe that more significant statutory changes may be called for than those supported by my colleagues.

The commodities industry is in a period of extremely rapid evolution. As recently as ten years ago, the futures markets were limited almost exclusively to their role in the marketing system for agricultural products. Trading was the business of sophisticated commercial groups and a small number of affluent and knowledgeable speculators. 2/ During this agricultural phase of futures market history, trading was appropriately regulated within the Department of Agriculture. 3/ The regulatory authorities concerned themselves primarily with contract terms, delivery points and other mechanisms for assuring honest and competitive agricultural prices. It was with the designation in 1975 of the first futures contracts on interest rates that the current period of unprecedented growth and structural change in the futures industry began. 4/

Congress had correctly perceived the onset of this new phase in 1974, and had transferred the regulatory responsibilities for futures markets from the Agriculture Department to a new independent agency. The establishment of the CFTC, with its broad mandate to approve economically useful futures contracts in virtually any good, article, right or interest, provided an environment of regulatory flexibility in which the industry's expansion could occur. 5/ There were only 12.4 million futures contracts traded in 1970; ninety percent of these were in agricultural commodities. 6/ By 1981, the annual volume had reached 101 million contracts, an eightfold increase. 7/ The single most active contract traded was the Chicago

Board of Trade's Treasury Bond contract, and approximately half the 1981 industry-wide volume was in contracts for non-agricultural commodities. The financial futures volume alone was almost double the industry's entire volume just a decade earlier. 8/

The growth of volume reflects more than a heightened level of commercial and floor activity. Innovative futures contracts have demonstrated a powerful appeal to public customers. Large numbers of non-professional speculators, some financially sophisticated and some less so, have been added to the ranks of futures customers. The total is usually estimated to be in the hundreds of thousands, and commission volume is said to have exceeded a billion dollars annually. 9/

Throughout the period of financial futures development, the commodities industry has taken pains to distinguish itself from the securities industry. Commodities spokesmen have been quoted often on the differences between securities investors and commodity speculators. The customer protection rules of the Securities and Exchange Commission have been commonly characterized as stifling, rigid, and too paternalistic to be applied to the futures world. 10/ The CFTC, by and large, has shared this view, and it has gone its own way in formulating a regulatory framework for commodities. 11/ If the long and stable first phase of industry development can be called the agricultural phase, the second must be the independence phase.

There are unmistakable signs today that a third phase is dawning. In the last few years, the distinctions between securities and commodities have rapidly eroded. The largest commission firms in commodities are not specialty houses; they are affiliates of the major securities firms. 12/ Commodities customers and securities customers are increasingly drawn from the same lists. Three of the oldest and largest commodity houses have recently merged with securities giants. 13/ The Chicago Board of Trade, which had cut all ties to its offspring, the Chicago Board Options Exchange, during the independence phase, is now talking of a reassociation. 14/ The New York Stock Exchange created its own commodities affiliate and then negotiated a cooperation agreement with the Chicago Board of Trade. 15/ I would feel safe in predicting that other commodities and securities exchanges will soon follow suit with their own affiliations or mergers. The approval by the CFTC just last week of an application to trade futures on a common stock index is a final proof that the lines have been blurred. 16/ The independence phase is quickly giving way to the merger phase.

Should this trend continue, the arguments for maintaining two separate regulatory agencies, and two distinct philosophies, will dissolve. If the industries become one, the CFTC and the SEC should consolidate as well. The 1982 reauthorization hearings, of course, need not be the forum for considering this combination. They can as easily be viewed to be the last hearings of the independence phase as the first hearings of the merger phase. My recommendations are premised on the assumption that the CFTC will survive the hearings as an independent agency.

The changing industry structure in itself provides guidance on one reauthorization issue. There is no reason to believe that the futures industry a few years from now will look any more like the futures industry of today than today's industry looks like the industry of 1978. Congress acted judiciously in establishing four year reauthorization cycles in 1974 and again in 1978. With industry fundamentals in a state of obvious flux, the period of reauthorization should be similarly short in this cycle.

The following comments on the substance of reauthorization go to numerous areas of the Act. On most of these, I have testified or written at length in connection with previous Congressional proceedings. Where this is the case, I have tried to summarize rather than repeat a lengthy presentation.

The issue on which I have testified most frequently is the need for a government presence in the fixing of futures margins. 17/ The 1929 stock market crash plainly demonstrated to the American people and the Congress that there is a public interest in the level of securities margins. The same public interest is present in futures margining, and I surely hope it will not require a genuine crisis to illustrate this point. 18/ While it is frequently observed that securities margining takes the legal form of an extension of credit while commodities margining does not, this difference has little to do with the issue at hand. Margins in both cases function as a threshold for the new customer. Decisions by most customers on whether to enter a market and decisions on how large a position to take are inevitably influenced by a comparison of the customer's available cash and the amount of margin required. Margins in both commodities and securities also play a role in the exit of traders from a market. The lower the initial margins, the greater is the chance that traders' positions will have to be liquidated against their will.

By drawing undercapitalized and uninformed speculators into a market, low margins may reduce the average level of fundamental price sophistication. By magnifying the capital of large speculators, low margins tend to amplify the risks of market domination by oversized position holders. Perhaps most important, low margins can cause personal cash flow considerations -- of traders both small and large -- to be substituted for fundamental market judgment in times of rapid price movement. The snowballing of margin calls can turn a routine price adjustment into an exaggerated swing or a larger correction into a panic.

The exchange governing boards are well equipped to adjust margin levels in order to protect the solvency of their members. They are not constituted to take account of broader economic issues in their decision-making. I would strongly recommend that Congress vest in either the CFTC or the Federal Reserve Board of Governors the duty to establish and adjust, as required, minimum levels of permissible margins for each futures contract. A minimum level established in this manner would serve as a floor below which exchange margins could not be reduced but above which the exchanges would retain their present flexibility and authority.

Even if exclusive exchange authority over margin levels is maintained, a number of incremental improvements are worthy of Congressional consideration. Few events in the commodities world would be as disastrous as the failure of the clearinghouse. Recent events have reduced the level of comfort in the industry with respect to the invulnerability of the clearing system. 19/ In the long run, I suspect that the public and the business community would be best protected by the formation of a unified, industry-wide clearing mechanism, protected against default by a federally chartered guarantee fund. In the short run, I would recommend two changes in the prevailing rules. 20/

Most clearinghouses today collect initial margins from member firms only on a net basis. A firm holding positions totaling ten thousand contracts on the long side of the market and ten thousand and one contracts on the short side is obligated to deposit the required margin for only one contract. This effectively makes each member firm a mini-clearinghouse, and it places too much dependence on the wisdom and good faith of a diverse population of members. In a crisis, this arrangement can precipitate a race by rival clearing organizations to see which one can first lay claim to a threatened member's assets. A statutory requirement that margins be collected on gross position sizes rather than the net balance would help assure the integrity of the clearing process.

The probability that any individual trader can injure the clearing system grows with the size of that trader's positions. At some clearinghouses, domestic and foreign, it is customary for clearing margins to be scaled with position size. This is not, however, the practice at the largest domestic clearinghouses. 21/ A statutory direction to require initial clearing margins in proportion to position size would serve to reduce clearinghouse exposure and, simultaneously, to make accumulation of oversized futures positions less attractive. The bursting of the silver bubble in March of 1980 would have been of far less concern had the precautions of gross margining and scaled margin levels been in effect before the trouble began. 22/

Among the most valuable devices for preventing the accumulation of oversized positions is the imposition of a speculative limit. 23/ Although direct limits on speculative position sizes can be circumvented by sufficiently determined violators, the lack of perfect enforceability is no bar to their usefulness with respect to most market situations and market participants. Conscious of the dangers imposed by large speculative positions for both the pricing integrity and financial stability of futures trading, the CFTC has determined that there should be a reasonable limit on the size of such positions in all markets at all times. 24/ This is a welcome and positive development. In connection with the pending establishment of limits by the exchanges, the CFTC has recommended a statutory amendment clarifying government's authority to enforce such limits. 25/ I support this proposal and I would urge an additional statutory change as well.

The CFTC's speculative limits regulation grants to the exchanges a considerable measure of discretion in setting the new limits. They will have to exercise this discretion without the benefit of a long experience period in many of the younger markets. All indications are that most exchanges will resolve doubts in favor of relatively permissive limits. 26/ Should a problem of congestion someday be perceived as arising even within the exchange prescribed limits, the CFTC will be powerless to intervene unless a genuine emergency is declared. Emergency powers are a poor substitute for precautionary medicines. The CFTC has the authority, after notice and hearing, to impose position limits of its own, but the statute specifically proscribes the CFTC from applying any such order to large positions already in place. 27/ It was this proscription that compelled the CFTC in 1979 to rely on exchange position limits with respect to silver; the exchanges have the authority to set retroactive limits while the Commission does not. The declaration of an emergency is an unnecessarily broad remedy for an isolated large trader problem. To rely on the exchanges to employ retroactive power over position sizes inevitably exposes them to conflict of interest charges. The CFTC should be permitted, after due notice and hearing concerning specific market situations, to require reductions of excessively large speculative positions. 28/

The shield of secrecy surrounding large futures positions should also be reexamined by the Congress. 29/ Small positions held by futures customers may be none of anyone else's business, but large positions have an impact on the entire market. Although secrecy may be of strategic benefit to the large trader, it is difficult to find a policy justification for not disclosing positions with a market-wide impact. 30/ Economic theory suggests that a market is most efficient when supply and demand information is most widely distributed among the market participants. While knowing what a large trader owns at any time is not a perfect substitute for knowing what the trader knows, the position itself reflects a reasonable share of any proprietary information. If positions are revealed, the gains from the inside information become partially available to others and the whole market becomes correspondingly more efficient.

The argument most commonly raised against disclosure is that, in an environment of accustomed secrecy, a leak or unanticipated release of trading data could lead to market disruption. This implies only that disclosure would have to be the rule rather than the exception. Releasing large trader positions on a regular basis would diminish, not increase, the risks of market disruption through improper or ill-advised publication of market-sensitive data. Whatever may be the merits of disclosing current positions, moreover, there would seem an even clearer case for the release of stale and no longer sensitive data. Information on closed positions, however, is permanently shielded as though it remained forever market-sensitive. There are numerous benefits to the release of historical information. Producer groups and academics could use past data to examine market performance and market structure and to evaluate the actions of regulators and self-regulators as well. Enhanced study of position records might similarly help the Congress in exercising its oversight responsibilities. Justice Brandeis once said that sunlight was the best disinfectant. It may also be the best precaution against the need for a disinfectant.

The problems to be addressed in reauthorization are not limited to those involving organized futures markets. One of the least tractable obstacles faced by the CFTC since its inception will be largely removed if the Congress accepts the Commission's recommendation on expanded jurisdiction of the states. 31/ Off-exchange dealers in commodity instruments have been routinely taking improper advantage of an ambiguity in the Act to shield themselves from appropriate state regulation and prosecution in state courts. 32/ No one ever intended the CFTC to be an exclusive national police force for all commodity related crimes. The allocation of jurisdiction between the CFTC and state agencies with respect to off-exchange instrument sales is less than clear in the Act as now written. It will be all to the good, for both the public and the CFTC, if the Commission's proposal for an explicit affirmation of state jurisdiction over off-exchange instruments is made a part of the law. 33/

The Commission proposal, however, retains a federal preemption of state regulation in two areas where preemption is hard to support. The constitutional philosophy of the United States reserves to the fifty states broad powers to protect their citizens. The states should be entitled to all benefit of the doubt concerning their right to make and enforce those laws which they believe will benefit their citizens. The federal government should forbid the states to exercise their sovereign police powers only when there is an overriding national interest in uniformity across state lines and only when the federal government is capable of assuming the full responsibilities of public protection.

No one has argued that each state should impose its own rules concerning the specifications of contracts traded on national futures exchanges. The need for uniformity in contract terms is apparent, and the CFTC is a sufficient regulator. Assuming the existence of a responsible National Futures Association, the same logic would apply to the retailing of futures contracts by national firms. It requires a stretching of the logic, however, to preclude states from regulating the marketing of commodity pool shares. Under the proposed jurisdiction accord endorsed by the CFTC and the SEC, the SEC will be given primary authority for overseeing the capital formation stage of commodity pool operations. 34/ This is presumably because pool shares are recognized to be neither hedging nor price discovery instruments; they are investment instruments. It is extremely difficult to distinguish them in this regard from mutual funds, and it seems accordingly inconsistent that the states should be permitted under the proposal to participate in the regulation of mutual funds but forbidden to play a parallel role with respect to commodity pools. 35/ Unless Congress determines that capital formation in commodity pools embodies some greater national interest than the same process in mutual funds, parity of treatment would be the more advisable course.

The preemption of state regulation with respect to what are known as "leverage" contracts is without a logical foundation. 36/ Neither the Congress nor the CFTC has ever identified an element of public interest in the sales of these deferred delivery instruments designed for speculation in precious metals. 37/ Leverage merchants, unlike retailers of pool shares, will not be regulated by the SEC. The fledging NFA intends to take no responsibility for overseeing their selling practices. 38/ The states would be entirely forbidden to regulate them under the CFTC's exclusive jurisdiction clause. So the CFTC, with a four person sales practice audit staff, would be their sole monitor. The CFTC staff believes it can do the job only if the leverage industry is restricted to the handful of firms which have enjoyed a federally imposed monopoly since 1978. 39/ These lucky firms would be granted by the proposed legislative package a continued exemption from state regulatory oversight and a continued exclusive franchise to protect them from competition. In this era of awakened interest in the role of the states under federalism, it is disturbingly anomalous that state jurisdiction over this one element of off-exchange speculation in precious metals should be precluded. The CFTC package does acknowledge that further study on the matter is in order. If the Congress desires any further study, it should at least lift the preemption of normal state regulatory authority during the period of the study. 40/

The two remaining topics, customer protection and the standards of approval for the trading of new commodity contracts, are of special importance as underlying themes in a variety of futures market issues. Although both subjects have been implicitly addressed in my previous testimonies, this is my first opportunity, and perhaps my last as well, to offer my views in a broader context. I would like, therefore, to address these topics at some length.

Customer Protection. When the Commodity Exchange Act was first drafted, there were very few commodity customers to protect and most of those were sophisticated enough to take reasonable care of themselves. Now that participation in futures and options trading has been extended to a general audience, including some customers possessing only the most casual familiarity with complex financial markets, the needs of the public have changed. The Act was conceived for an era which has passed. And its relative silence on customer protection issues has been interpreted too frequently as an absence of legislative mandate for the customer protection rules that today's markets so plainly require. Reauthorization provides an opportunity for Congressional direction which can help to bring the development of the industry's customer protection standards into step with its remarkable new product evolution.

The greatest weaknesses in commodity customer protection today are at the retail level. Despite an increasing similarity in both products and audience for marketers of commodities and securities, the commodities industry is substantially behind the state of the art developed in the securities industry over the years to protect customers from retailing abuses. 41/ There is no requirement for uniform training or testing of sales personnel in the futures business. There are no suitability rules to restrict what an overzealous retailer may urge upon a commodities customer. There is virtually no self-regulatory police force to see that standards presently existing are enforced. Each of these failures serves to place the commodities customer in an unnecessarily vulnerable position.

The securities business has operated with all of these protections in place for decades. 42/ The most reputable commodity firms have created their own in-house training programs, suitability standards, and compliance mechanisms. Less scrupulous firms, on the other hand, are free to have none of these safeguards. In a sense, one could describe the commodities retailing community as operating on a sort of honor system in which each firm can select its own standards of practice.

Everyone recognizes the right of a customer to adequate disclosure of risk. Without uniform training and testing of commodities sales personnel, customers can be deprived of any useful disclosure even by a well-intentioned sales representative who simply lacks an adequate knowledge of the product being sold. This variety of ignorant misrepresentation represents an escalating danger as the expanding marketplace calls for rapid recruitment of inexperienced sales personnel and as new and complicated derivative instruments, such as options on futures, are introduced. The Commission favors training and testing; at least one exchange requires it of member firms; and the NFA intends to initiate a testing program as soon as it is mature enough to do so. 43/ This, however, is not sufficient. Congress should seriously consider requiring a proficiency testing program as a prerequisite to the marketing of any option or securities-based product. Industry-wide testing would probably follow quickly.

In the absence of suitability standards, it may well be legal for a commodity retailer to urge the proverbial widows and orphans of securities lore to risk their life savings or inheritances on positions so speculative or so large that they could be wiped out in a matter of hours. Recommendations urged upon securities customers, on the other hand, must be determined by the broker, and in some cases an office supervisor, to be suitable for the financial means and investment objectives of the customer. 44/

Suitability rules are often mischaracterized as attempts by government to determine whether individuals will be permitted to enter into transactions of their own choosing. They are, in fact, designed to influence only the behavior of sales representatives in recommending transactions to customers. The CFTC was urged by an advisory committee, comprised mostly of futures industry professionals, to establish suitability rules in 1975. 45/ After considerable debate, it declined to do so. 46/ In 1979, the CFTC staff revived the issue by proposing that suitability standards be adopted in connection with exchange-traded options. The Commission rejected this proposal as well. 47/ Democratic government may never be able to prevent people from making fools of themselves. We should be able to discourage government licensees from taking advantage of those who trust them. Suitability rules are a minimum standard in this regard. It may now take the direction of Congress to assure that this minimum standard is met.

The absence of a regulatory or self-regulatory monitoring capability with respect to sales practices in the futures business is especially worrisome. The SEC's staff is roughly four times the size of the CFTC staff, and it is supplemented by an NASD with 800 employees and with a mandate specifically directed toward the maintenance of high standards in securities marketing. 48/ The CFTC has a small enforcement division and an even smaller sales practice audit staff. 49/ The exchanges have always been candid in acknowledging that their rules and audit procedures seldom extend to influencing front-office retail practices. 50/ The futures industry has recognized that a gap is present, and the proposal for a National Futures Association is an appropriate response. Unfortunately, no one is able to reassure the Commission that NFA will soon be able to accept the responsibilities of sales practice supervision. 51/ The promise of an NFA has been long discussed in connection with new contracts which would enlarge the ranks of futures customers. At some point, that promise must be realized.

Congress may wish to take this opportunity to make clear that retail sales supervision is mandatory for a healthy and competitive market environment. There is little disagreement on this at the level of principle. The best contribution of reauthorization in this area would be to raise the priority placed by the industry on enhanced self-regulation by conditioning further growth in the customer base on better protections. 52/ It is unfortunate enough that the requisite protections are lacking in traditional futures market domains. It would be all the more unfortunate if the approval by the CFTC of futures on securities serves to dilute customer protections where they have traditionally functioned well.

The need for vigilance, of course, extends to the exchange floor as well as the branch office. Floor brokers occupy a position of trust which, like other positions of trust, can be honored or abused. The customer in a futures trade, unhappily, has no direct way of knowing how scrupulously the trust was honored. A dishonest floor broker can hold a customer's order in his pocket while executing an identical order for an unspecified account, then decide later whether the trade was for himself, a colleague, or the customer. A broker can place his favored customers' large orders ahead of his smaller customers' earlier orders. Brokers can signal one another of an impending market pulse and thus allow the entire bid-ask spread to be moved to the detriment of customers in general. There is no way to be certain whether any of these abuses occur frequently enough to be a cause for substantial concern. Present technology permits no audit trail. 53/

In securities, a floor broker is not permitted to trade simultaneously for himself and his customers. 54/ This practice, known in commodities as dual trading, is prevalent on the commodity exchanges. 55/ Order executions in securities are time-stamped to permit sequencing and reconstruction of trading patterns for subsequent examination. Time-stamping more precise than to the nearest half hour has been described as infeasible in busy commodity pits. At the largest commodity exchange, executed orders are still dropped on the floors where they are picked up by runners for subsequent recording. 56/ Congress was sufficiently concerned about commodity floor practices that, in 1974, it instructed the CFTC to conduct a study of dual trading and provided authority for the Commission to ban, limit, or condition dual trading on the exchange floors. 57/

The Commission quickly found itself in a dilemma it has never resolved. The extent of dual trading abuses could not be measured without an ability to reconstruct the sequence of trading. At the same time, every feasible method of sequencing required at least some change in the traditional technologies of the floor. The exchanges argued that a change in their accustomed methods should not be forced upon them absent a showing of abuse, while all parties agreed that no showing of abuse could be made without those changes which would permit trade sequencing. 58/

The CFTC, after laborious deliberations, sought a middle ground between the need for sequencing and the desire for minimum disruption of prevailing floor methods. Exchanges were instructed to time-stamp each trade report to the nearest one minute. 59/ The result would approximate genuine sequencing, and the staff indicated that the requirement would be technologically feasible. 60/ Several commodity exchanges complied, but the leading exchanges complained that even time-stamping to the nearest minute would slow the trading in their most hectic pits. 61/ The CFTC reconsidered its position and ultimately decided to accept bracketing of trades to the nearest thirty minutes instead of the nearest one minute. 62/ A thirty minute period is long enough for many of the feared abuses to occur within its time window and the data from thirty minute bracketing is too imprecise for use in the type of study originally contemplated. The questions posed by the Congress, therefore, remain unanswered.

If the Congress wishes a definitive response, it will most likely have to condition the continuation of dual trading at each exchange upon the exchange's willingness to provide accurate time sequencing. Alternatively, Congress may wish to let market forces aid in the solution. For reasons of private interest, it is probable that there will be changes soon in the traditional technologies of the pit auction. The demands of volume and the need for extended trading hours will force a modification of the nineteenth century techniques in use today. Congress should, at a minimum, make certain that whenever a new technology is developed it includes the capacity for accurate timing and sequencing of executed orders.

A final and more general point about customer protection is also in order. If self-regulation and government regulation are the two front lines of defense against abusive practices, the courts constitute an indispensable third line of defense. Neither self-regulatory arbitration nor the CFTC's reparation system is an adequate substitute for the right to bring an action in a court of law. Arbitration achieves speed at the sacrifice of a written record and a written opinion. An arbitration judgment, consequently, can not be held to a standard of consistency with the common law, with the Act or even with other arbitrations. A customer reparations program at the CFTC, designed to provide litigants with all of the same rights assured by the Administrative Procedure Act, has proven itself too weighty a burden for the Commission's limited judicial apparatus. 63/ The legislative proposal of the Commission recommends a more flexible approach to the adjudication of reparations complaints. 64/

The CFTC proposal is positive and appropriate as long as the reparations program can be viewed as a supplement to the aggrieved citizen's traditional rights of suit. In cases presently pending before the United States Supreme Court, however, the right of commodity customers to bring suits under the Act has been challenged. 65/ The Commission has voted to maintain its support for private rights of action under the Commodity Exchange Act. It has, to the same end, voted to request an explicit affirmation of these rights in the Act should its present position be rejected by the Supreme Court. On this, the entire Commission is in agreement. 66/

There is less than unanimous agreement on a related issue, however. While the Commission has reiterated its support for private rights of action against individual violators of the Act, the majority has voted to favor an exemption on behalf of commodity exchanges from any private lawsuits filed against them in connection with their self-regulatory duties. 67/ I do not concur in the Commission's argument that exchanges are entitled to such a broad grant of immunity by analogy to government agencies. The case for self-regulation depends on the presence of a coincidence and congruence between the preferences of reputable private parties and the public interest. When an individual believes that he or she has been injured by a breakdown in that congruence, there must be recourse. Government power is bestowed on public servants only temporarily and only as conditioned by the full system of checks and balances as well as a host of prohibitions on conflicts of interest. 68/ It should not be bestowed on private and interested parties without adequate judicial scrutiny.

The Commission believes itself to be a sufficient overseer of the self-regulatory powers vested with exchanges, and it fears that exposure to liability would chill the self-regulatory inclinations of the exchanges. 69/ Earlier, however, the Commission had taken the position in court that it could not provide adequate remedies or compensation for parties injured as the result of unlawful self-regulatory activity or negligent inactivity. 70/ With respect to the chilling effects on commodity exchanges of potential liability, the Commission had earlier commented that any such danger could be ameliorated by the use of a liability standard which balanced the inhibitive effects of a right of action against the beneficial effects of judicial scrutiny. 71/ The Commission turned away from this approach at its recent meeting when it rejected a proposal to permit private rights of action against exchanges in cases alleging gross negligence or gross dereliction of self-regulatory duties. 72/ The previous position of the Commission on this matter is more sensitive to the requirements of public protection than the CFTC's current view, and I hope that the Congress will assure that there are no unwarranted barriers to the right to bring private lawsuits under the Commodity Exchange Act.

Approval of New Contracts. The futures industry has been transformed by its own new products in recent years. Another wave of innovative products is emerging now with the potential for an equally dramatic impact. The Commission last year authorized the first futures contracts calling for cash settlement in lieu of physical delivery. 73/ The Commission has voted to permit exchange trading of options on futures, and it is prepared to support a fresh look at the longstanding ban on agricultural options. 74/ Just a few days ago, the Commission approved a controversial application for futures trading on an index of common stocks. Consistent with a stated goal of expediting the consideration of new product applications, the CFTC has authorized some nineteen new contracts within the last year. Before us and pending approval are applications to trade futures on seventeen additional common stock groupings and on the prime rate. 75/

When economic historians look back on this part of the Twentieth Century in America, one can expect them to pay close attention to our dismally low rate of real capital formation. By the standards of this country's past and by comparison with our industrial rivals today, America is simply not investing sufficiently in its own future. 76/ Many explanations are available, placing the blame variously on government deficits, on rigidities in wages and prices, or on the lack of personal savings incentives. There is probably an element of truth in most of the widely held theories, but I also believe it is far from coincidental that the slowdown in capital formation should be occurring at a time when speculation is so widespread. Along with pure gaming in casinos, pools and lotteries, speculating on real estate, precious metals, the stock market and commodities has replaced baseball as the national pastime. At no time in American history, with the possible exception of the late 1920's, has the hunger of our people for a quick buck been greater or more evident. 77/

Speculative fever is not a prime mover in the decline of capital formation as much as a symptom of the deeper causes. It may, however, intensify the basic economic problems and help the absence of real growth to become a self-fulfilling prophecy. Chronic inflation is probably the worst enemy of capital investment. Facilitated by natural processes of age in the U.S. economy and by our weakened worldwide competitive position, inflation has introduced an uncertainty and dimmed the prospects for high real returns in American industrial investment over long periods. Savers and lenders have thus focused on the short end of the financial time horizon where, unfortunately, there is little opportunity for building the future. The more this concentration in short term instruments occurs, the worse the economy's long term prospects will actually be and more the real capital sector will continue to deteriorate.

The ultimate short horizon investments are those with perfect liquidity, those which can be bought today and cashed in tomorrow. New manufacturing plants can never meet that test, but speculative positions in active markets come relatively close. When nominal interest rates are high and real rates are low, moreover, those speculative investments which embody a high degree of financial leverage take on an additional measure of appeal. 78/ Speculation under these circumstances may provide the only hope many investors have for high returns over short periods. The remarkable growth of the futures markets during the last decade undoubtedly owes much to the underlying conditions which favored short maturities and high leverage.

It is commonly said in defense of speculation that it can occur without limit at a zero cost to the real economy because, rather than consuming physical capital, it merely shifts money from one hand to another. The truth is neither so simple nor so rosy. Concentration on unproductive speculation, at the very least, absorbs the time and talents of all who participate. This cost is hard to measure but unquestionably large. A count must include all the career people who advise, sell, and trade in the various speculative markets and all those who work in the pure gaming industries. To this total would be added all the time and energy devoted to speculation by the amateur participants. Some of this cost is reimbursed to the economy as a whole in the form of efficient markets; most of it is not. The loss is surely not trivial in a society which needs all the constructive effort it can muster.

Widespread speculation may have a diversionary impact on the supply of investment funds as well. Real capital formation dollars and financial speculation dollars do not come from the same finite pool in the simplest sense. Capital formation and speculation do, however, compete for the attention of the same risk-takers, and they operate on the economy's liquidity structure in competing and incompatible ways. An economy which devotes its financial resources to plant and equipment development must sacrifice some degree of liquidity in the composition of its financial assets. Individuals living in a society which emphasizes speculation, on the other hand, must stay highly liquid in order to meet the next margin call or enter the next position. The more the public seeks to maintain the liquidity necessary for speculative activities, the smaller will be the supply of funds available for twenty or thirty year real asset commitments.

This trade-off creates a logical dilemma for the current Administration, which places a supply-side emphasis on the growth of our real capital base, but also wishes to maintain a laissez-faire attitude with respect to regulation and questions of allocation in financial markets. 79/ Speculation thrives in the marketplace, and it has powerful constituents within the financial community. If, at the same time, massive speculation is detrimental to the growth of industrial capital, the Administration will not be able to serve both masters well. Government, moreover, has no option to take a neutral stance. That fostering long term growth is a responsibility of government is accepted by conservatives and liberals alike. Numerous elements of federal tax, expenditure and monetary policies inevitably influence the incentives that determine our national economic priorities. A government wishing to stimulate growth can not be a promoter of more speculation.

The commodities industry and the CFTC are, of course, only minor players in this drama. Neither are to blame for the macroeconomic problems of the nation. Nonetheless, because speculation in futures has grown so rapidly and because government policy toward futures markets is still in a formative stage, the broader issues are particularly well framed in this context. Virtually every economist would agree that speculation in futures markets, when conducted in moderate amounts by knowledgeable participants, is a contributor to microeconomic pricing efficiency. 80/ The issue requiring scholarly and Congressional attention today is the impact of speculation, particularly when carried beyond moderation, on macroeconomic goals. 81/ The CFTC staff, understandably, has not sought to examine all of the macroeconomic consequences of futures speculation in connection with new contract applications. Its approval process has a narrower focus in keeping with the current state of the law. Reauthorization provides a useful opportunity for the Congress to reconsider and sharpen that focus.

Congress has never considered the marketplace test sufficient for the justification of a new futures contracts. Pure gambling has always held its own in free market situations, and so have sales of contrabands. The existence of willing buyers and willing sellers is a necessary condition for the creation of a new futures market, but it is not the only standard by which a new trading instrument should be judged. Congress has expressed its desire for a more substantive test by requiring a determination that each new contract will not be "contrary to the public interest". 82/

The legislative history of the public interest test makes clear that the Congress wished to have the CFTC approve only those futures contracts which would serve a genuine economic purpose and to preclude contracts used entirely or almost entirely for speculation. 83/ Consistent with this legislative history, the CFTC codified its standards in a statement that each new contract would be required to show potential for "more than occasional" commercial hedging or price basing. 84/ Implied in this formulation is that the commercial activity to be served is of important positive benefit to the economy. Players on a professional sports team could hedge their earnings prospects in a contract on the team's record. Dealers could hedge and discover the market prices in an illicit drug contract. These contracts would never be filed by an exchange or approved by the CFTC. The difficult questions arise when a valid economic purpose to be served by a contract is weighed against potentially detrimental effects of trading.

Some observers hold the view that the commercial purpose standard for a contract is met as long as there exists any hedging potential at all, however remote or limited. The actual process of CFTC consideration focuses heavily on the identification of likely hedgers and the terms that affect their use of the contract. The specifications are carefully examined to assure fairness to those who would deliver or take delivery under the contract. The CFTC staff will suggest changes in the specifications if it finds that the contract is easily susceptible to manipulation. It will determine whether the exchange submitting the contract is complying with applicable laws and regulations and whether it is maintaining a sufficiently vigilant program for enforcing its own rules. On some contracts, there is consultation with other government agencies about concerns in their areas of responsibility. 85/ By the time these tasks, and others that may be occasioned in a specific case, are completed, the application has generally been improved over the original submission. The contract then moves forward to final approval. No contract application has ever been denied by the CFTC.

Exchanges often complain that the approval process is time-consuming. This is true, but it is nonetheless valuable. Competition between exchanges can test only some of a new contract's terms and specifications. To assume that no unfair advantage is taken at the expense of the commercial and producer communities, some degree of oversight has always been seen as necessary by the Congress and the regulatory agencies. My concern in this area is not with the questions asked but with the questions not asked.

The public interest test ought not to be viewed as a binary, yes or no, exercise in which commercial value is found to be either present or absent. Commercial value is a matter of degree and the public interest test ought to be a weighing of costs and benefits. The benefit side of the equation for a new futures contract includes the hedging and price discovery purposes it will serve. A contract expected to be utilized heavily in commerce conveys more benefits than one lightly used. On the cost side, the test must consider any predictable dangers of abuse with respect to the likely customer population, any adverse effects that may be felt in underlying cash markets, and the impact on macroeconomic capital formation that may be caused by a high level of speculative activity.

Commodity options trading in its earlier incarnation offered a good illustration of how abusive retailing practices can undermine the public interest in a trading instrument. Both Congress and the CFTC eventually reached the conclusion that the abuses were so great as to overwhelm any benefits from off-exchange options trading. Commodity options were banned as a result, and the Congress ordered that they remain banned until the CFTC had documented its ability to regulate them successfully. 86/ Although the CFTC's proposed system of protections remains behind the present state of the art in options trading on national securities exchanges, the options program of the CFTC is distinctly superior to its customer protection program in futures markets. It contains an enhanced disclosure rule with respect to the opening of accounts and it requires exchanges to establish rules and audit programs for the monitoring of member firm retail practices involving options. 87/

Were the Commodity Exchange Act to express the same explicit concerns about customer problems in futures contracts that it expresses in the case of options, the CFTC could use the contract approval process to upgrade the industry's level of customer protection generally. Under current law, the staff is reluctant to suggest that any new futures contract be held to a higher standard than the futures contracts which preceded it. It was on this basis that stock index futures, which several agencies of government have warned us may embody substantial potential for customer abuse, were approved by the CFTC with a set of protections markedly weaker than those applied to options. 88/

Consideration of the effects that the terms and conditions of a proposed futures contract will have on the underlying cash markets is a significant part of the CFTC review process. Neither the staff nor the exchanges are asked to project speculative activity, however, and consequently the effects of speculation in the proposed contract on underlying markets are less studied. While it is true that a moderate amount of speculation carried on by well informed individuals should aid in the efficiency of markets, it is just as true that immoderate or uninformed speculation is likely to hurt pricing efficiency. 89/ Part of the contract approval process should be an evaluation of means to hold immoderate and uninformed speculation in check.

The recent adoption of a rule requiring position limits in all markets may be viewed as a useful step in this direction. Position limits should reduce the problems caused by excessively large traders. Remaining, however, is the problem caused by masses of smaller uninformed traders. Under the CFTC's present reading of the Act, no distinction is drawn on the basis of whether the hedgers who use a market are accompanied by a few hundred, a few thousand or a few million speculators. Many of the currently successful futures markets are predominantly speculative, some with a hedging interest of ten percent or less. 90/ Some degree of knowledgeable speculation is necessary to lubricate the machinery of the futures markets. It does not follow from this observation that, beyond the point of adequate liquidity, more speculation is always better. There is every reason to believe that market efficiency is adversely affected by the presence of undercapitalized and ill-informed participants. This will be especially the case during a time of market disruption or rapidly changing fundamentals.

The best policy device for limiting excessive speculative participation is margin control. Selective use of margining powers can adjust the prospective level of public speculation to that required as a market lubricant and keep it from overwhelming the commercial participation. If the present vesting of margin authority with the exchanges is maintained, the CFTC should at least be empowered to seek assurances during the designation process that the exchanges' authority over margins will be used in this manner.

The grand question, whether massive speculation has an adverse macroeconomic effect on capital formation, is never considered by the CFTC as a part of contract designation. It transcends any single contract application, and it also transcends the mandated expertise of the Commission. Nothing we do consider, though, is of equal importance. The role of futures markets in the economy will ultimately be judged more on macroeconomic grounds than by the narrower standards applied day to day. The Congress may wish to consider requiring a periodic interagency study of the macroeconomic questions. The Department of the Treasury, the Securities and Exchange Commission, and the Federal Reserve Board of Governors would be natural candidates for participation with the CFTC on any such studies. 91/

The meaning of the Act's public interest test should, meanwhile, be clarified to dispel the notion that it is one dimensional and binary. The potential for abuses with respect to customers, the micro-efficiency impacts of anticipated speculation, and the broader macroeconomic theory questions should all be elements in the designation equation. Where deficiencies are found there should be a maximum of emphasis on the improvement of the application. A marketplace test, of course, is needed as well. Because, however, the marketplace is not designed to judge all of the elements of the public interest, periodic review of actual trading performance should be viewed more as a supplement than a substitute for the process of prior approval. A prospective and analytical test, however difficult to perform, has always been required of the Commission under the Act. This continues to be both proper and necessary. An explicit prior weighing of the costs and benefits, including the anticipated degree of commercial value, should accompany the marketplace as the judge of new futures markets.

Deregulation is the fashion in Washington today. In the spirit of deregulation, various proposals have been offered which would strip the Commodity Futures Trading Commission of much of its present authority over futures and option markets. 92/ Whatever may be the merits of deregulation in other commercial areas, a reduction of government oversight in futures and option markets would be contrary to the country's needs and inconsistent with the industry's own development. With the expansion of these markets and their enlarging role in the aggregate economy, there should be more, rather than less, public attention paid to them. I hope the Congress will embrace the constructive proposals of the Commission and will also consider the additional matters I have raised in this testimony. Please do not hesitate to call on me if I can be of service during the deliberations.

Very truly yours,

James M. Stone

James M. Stone

1/ The Commodity Exchange Act, as amended, 7 U.S.C. §§1 et. seq. (1976 and Supp. III 1979). It will be referred to in this letter as the Commodity Exchange Act or, simply, the Act.

2/ The distinction between commodities and securities customers was described in 1973 by W. R. Poage, then Chairman of the House of Representatives Committee on Agriculture as follows:

> "Securities markets attract the small speculator, with a limited exposure to loss, futures speculation is normally limited to the more venturesome and solvent speculator." 119 Cong. Rec. 41, 335 (1973).

Also See Johnson, P., "Commodity Futures Trading Commission Act; Preemption as Public Policy", 29 Vanderbilt Law Review 1, 23 (1976); and Johnson, P., "The Perimeters of Regulatory Jurisdiction Under the Commodity Futures Trading Commission Act", 25 Drake Law Review 61, 62-5, (1975).

3/ Regulatory Authority was provided to the Secretary of Agriculture by by the 1922 Grain Futures Act, Ch. 329, 42 Stat. 998. It was later delegated to the Commodity Exchange Authority within the Department of Agriculture.

4/ The Commission designated the Chicago Board of Trade as a contract market in mortgage certificates guaranteed by the Government National Mortgage Association on September 11, 1975. A contract on 90-day Treasury Bills was approved for the Chicago Mercantile Exchange shortly thereafter.

5/ Section 2(a)(1) of the Act defines commodities over which the Commission has exclusive jurisdiction to include those specified and predominantly agricultural products in which there was futures trading prior to 1974 "and all other goods and articles, except onions . . . , and all services, rights and interests in which contracts for future delivery are presently or in the future dealt in . . . ."

6/ Source: Commodity Futures Trading Commission Annual Report 1981, p. 126.

7/ Ibid.

8/ There were 11,973,459 U.S. Treasury Bond contracts traded on the Chicago Board of Trade in the fiscal year ending September 30, 1981, each with a face value of $100,000. On November 25, 1981, the CBOT's T-Bond contract set a record for the highest volume in a futures contract in a single day, with over 131,000 contracts traded. Financial futures trading in fiscal year 1981 accounted for 19.8 percent of total futures volume. Source: CFTC Annual Report, Op. Cit., and "Comment on Futures", a newsletter published by Donaldson, Lufkin, Jenrette, Inc. (January 22, 1982).

9/ There is no official record of the number of futures market customers. Industry officials have been quoted as putting the figure in the hundreds of thousands. See "Questions on SEC-CFTC pact linger", Chicago Sun-Times, December 30, 1981.

One might verify that estimate by analogy to the securities industry. According to a 1980 New York Stock Exchange study, there are 6,209,000 active accounts held by brokerage firms. The accounts were handled by 200,000 registered representatives according to records of the National Association of Securities Dealers. There are approximately forty-five thousand associated persons presently registered with the Commission. If each registered Associated Person handled half as many accounts as the average registered representative, the number of futures market participants at any one time would have to be in the neighborhood of 683,000. If each Associated Person handled only one-third as many accounts, the number would be approximately 454,000.

According to David Johnston, Senior Vice President of E.F. Hutton & Co., gross commissions for U.S. futures exceeded one billion dollars in 1979 and were more than ten times greater than gross commissions in 1970, Commodity News Service, March 5, 1980.

10/ See Record of CFTC Open Meetings and public comment letters with respect to staff proposals for the commodity option pilot program, 1979 and 1980.

11/ In fashioning its anti-fraud rules, for example, the Commission determined not to track the anti-fraud provisions of SEC Rule 10b-5, 17 CFR 240.10b-5, out of concern that such "might invite an uncritical application of securities law principles and practices" to what it viewed as the distinct area of commodities. 40 Fed. Reg. 26504 Commodity Futures Law Reporter (1975-7 Transfer Binder) (CCH) Paragraph 20,049.

12/ According to sources in the CFTC's Division of Trading and Markets, the largest securities firm, Merrill, Lynch, is also the largest producer of commodities business with over $160 million in commissions on futures during fiscal 1980. At least six other major broker-dealer firms are among the top commodities commission producers as well, with fiscal 1980 commissions in excess of $25 million each.

13/ During the fall of 1981, the commodities firm of J. Aron & Co. was acquired by Goldman Sachs & Co. and ACLI Commodities merged into Donaldson, Lufkin & Jenrette. Phibro and Solomon Brothers consolidated in October of 1981 to create one of the largest diversified commodities and securities houses.

14/ See Chicago Board of Trade press release "CBT-CBOE Joint Trading Venture", December 2, 1981.

15/ The CFTC designated the New York Futures Exchange on May 28, 1980, as a contract market for five currencies, and on July 15, 1980 as a contract market in 90-Day Treasury Bills and 20-Year Treasury Bonds. The New York Futures Exchange, an affiliate of the New York Stock Exchange, opened trading on August 7, 1980. Its proposed link to the Chicago Board of Trade was announced the following year. See Chicago Board of Trade press release "CBT members vote to establish CBT/NYFE Link", December 14, 1981.

16/ On February 16, 1982, the CFTC designated the Kansas City Board of Trade as a contract market to trade futures contracts based on the Value Line Average, an index of common stocks. See CFTC press release No. 885-82, February 16, 1982.

17/ My views on the subject of commodity margins are set forth in greater detail in my testimony of May 1, 1980 before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee Agriculture, Nutrition, and Forestry; in testimony of May 21, 1980 before the Subcommittee on Conservation and Credit of the House Agriculture Committee; in testimony of May 29, 1980 before the Senate Committee on Banking, Housing, and Urban Affairs; and also in "Additional Comments on the Interagency Study of Silver Markets," prepared in connection with Section 21 of the Commodity Exchange Act, Pub. L. No. 96-276, 96th Cong. 2d Sess., Section 7, 94 Stat. 542 (June 1, 1980), and presented to the Subcommittee on Conservation, Credit and Rural Development of the House Agriculture Committee in connection with hearings on October 1, 1981.

18/ President Roosevelt in a March 26, 1934, submission to Congress proposed higher margins to restrict both securities and commodities speculation. He stated:

> "The people of this country are, in overwhelming majority, fully aware of the fact that unregulated speculation in securities and in commodities was one of the most important contributing factors in the artificial and unwarranted 'boom' which had so much to do with the terrible conditions of the years following 1929.
>
> I have been definitely committed to definite regulation of exchanges which deal in securities and commodities. In my message I stated, 'It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.'"

Congress accepted President Roosevelt's recommendation with respect to securities margins but did not act to provide regulation of commodities margins. See Public Papers and Addresses of President Roosevelt, Vol. 3, Document 52, page 170, Random House (1938).

19/ After the events in the silver market during March of 1980, one prominent attorney who had represented a large clearing member of Comex commented that, "Clearing associations will not cover a default if it means committing economic suicide. When those who are in the good to the last drop (clearing) system are called for huge amounts of money in the event of a cataclysmic default, you can be certain they will call their lawyers not their bankers." Source: The New York Times, April 13, 1981. Subsequently, the Commodity Exchange Inc., and the Coffee, Sugar and Cocoa Exchanges amended their rules to create or strengthen clearinghouse guarantee funds. 46 Fed. Reg. 15192, 27366 (1981).

20/ These recommendations were previously communicated to Congress in June of 1981 in "Additional Comments on the Interagency Study of Silver Markets", Op. Cit. 17.

21/ See clearinghouse notices to members, July 7, 1981 and January 7, 1982, Coffee, Sugar and Cocoa Exchange for an example of how such a margining system could operate. Compare By-Law 604, Board of Trade (Chicago) Clearing Corporation.

22/ To assure the gross margining of futures and margins levels scaled to the size of positions, Section 5 of the Act could be amended to condition designation of a contract market upon provision for these precautions. The Commission has recently proposed a new Rule §1.58, which would require positions held in an omnibus account by a non-clearing member to be margined on a gross basis. 46 Fed. Reg. 62864, December 29, 1981.

23/ I presented testimony on this subject at hearings on "Price Volatility in the Silver Futures Market" before the Subcommittee on Agricultural Research and General Legislation, Senate Committee on Agriculture, Nutrition, and Forestry, May 1, 1980. Additional remarks on this subject are contained in my 1980 Kimber Memorial Fund Lecture, Toronto, Canada, October 7, 1980; and Address at Conference on Financial Futures Sponsored by Columbia University Business School, New York City, January 29, 1981.

24/ Commission Rule 1.16, adopted October 1, 1981, requires all contract markets to establish speculative position limits on all currently traded futures contracts where position limits are not already in effect.

25/ See "CFTC Summary of Legislative Proposals", Section 4a(5) p. 10.

26/ See "CBT Committees Sharply Divided on Recommended Speculative Limits" Commodity News Service, January 6, 1982. CNS reported that the Chicago Board of Trade's financial instrument committee had recommended a 10,000 contract speculative position limits on most CBT interest rate futures contracts, while the Exchange's Business Conduct Committee recommended a 1000 contract limit.

27/ Section 4a of the Act provides that: "the Commission may from time to time, after due notice and opportunity for a hearing. . . fix such limits on the amount of trading which may be done or positions which may be held by any person under contracts of sale of such commodity for future delivery . . . as the Commission finds are necessary to diminish, eliminate or prevent such burden (excessive speculation) . . . *Provided, that such position limit shall not apply to a position acquired in good faith prior to the effective date of such order*." (Emphasis supplied).

28/ This could be accomplished simply by the deletion of the proviso clause set forth and underlined in note 27.

29/ *See* James M. Stone, "Disclosure of Large Position Information", a speech at the Annual Convention of National Cattlemen's Association May 1, 1981. Also "Additional Comments on the Interagency Task Force of Silver Markets", Op. Cit. 17.

30/ *Compare* Trade testimony at hearings of the Senate Agriculture Committee 67 Cong., 1st Sess., (1921), Page 410.

31/ The Commission has recommended to the Congress an amendment of Section 12(e) of the Act to read:

> "Nothing in this Act shall supersede or preempt: (1) any Federal criminal statute; (2) any Federal or State statute, including any rule or regulation thereunder, that is applicable to any transaction in or involving any commodity, product, right, service or interest which is not conducted on or subject to the rules of a contract market or subject to regulation by the Commission under Section 4c or 19 of this Act; or (3) the application of any Federal or State statute, including any rule or regulation thereunder, to any person required to be registered or designated under this Act who shall fail or refuse to obtain such registration or designation. The Commission is authorized to refer any transaction or matter subject to such other Federal or State statutes to any department or agency administering such statutes for such investigation, action or proceedings as the department or agency shall deem appropriate."

32/ *State* v. *Monex International, Ltd.*, 527 S.W. 2d 804 (Tex. Civ. App. 1975), *application for writ of error refused*, (Tex. Sup. Ct. No. B-5658, December 17, 1975); *International Trading Ltd.* v. *Harvey L. Bell*, Docket No. 77-96, Sup. Ct. of Arkansas (cert. denied); *Smith* v. *Green Valley Foods, Inc.*, Case No. 78-742 (Fla. Dist. Ct. App. 3rd), (January 9, 1979); The Commission has generally supported a strict interpretation of its exclusive jurisdiction clause.

33/ The CFTC proposal, quoted above in Note 31, received a favorable reception from its Advisory Committee on State Jurisdiction at that committee's February 5, 1982, meeting.

34/ See Commodity Futures Trading Commission/Securities and Exchange Commission Joint Press Release 853-81, December 7, 1981, and Commodity Futures Trading Commission/Securities and Exchange Commission Joint Explanatory Statement 882-82, February 2, 1981. The text reads in part:

> "While the CFTC has adopted extensive regulations governing the activities of commodity pool operators and has exclusive jurisdiction with respect to "accounts . . . involving" futures, the SEC has taken the position that the activities of a commodity pool as a company, i.e., its formation, capital-raising, and continued corporate existence, are subject to the federal securities laws. The draft legislative language would make this result explicit by stating that nothing in the CEA affects the applicability of the Securities Act and the Exchange Act with respect to securities issued by commodity pools and transactions herein. Of course, the proposed language would not affect the exclusive jurisdiction granted by the CEA with respect to state regulation. . . ."

35/ Mutual funds are subject to SEC regulation under both the Securities Act of 1933, 15 U.S.C. §77, the Investment Company Act of 1940, 15 U.S.C.§80a. Sections 18 and 50, respectively, of these Acts preserve state power to regulate as well. Commodity pools are legally distinct from investment companies.

36/ The Commission's provision for leverage firms in its legislative proposal is contained in the exception language of proposed Section 12(e) for contracts regulated under Section 19 of the Act and in new proposed language for Section 19 itself. It provides for a moratorium on the entry into the business of new firms until September, 1984, and further provides that within two years following the effective date of the provision, the Commission will conduct a study of leverage transactions and shall submit a report to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition, and Forestry.

37/ The need for further study on the public interest in leverage transactions is questionable in the light of the long history of consideration of this subject by this Commission. Commission exclusive jurisdiction over gold and silver bullion and bulk coin leverage transactions was established by Section 2(a)(1) of the Act and Section 217 of the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. §15a(1976). It was provided at that time that, should the Commission determine leverage transactions to be contracts for future delivery, the Commission was to regulate these transactions as futures contracts. The Commission began to study the subject of leverage transactions

37/ Continued

shortly thereafter. A study had previously been prepared by the Commodity Exchange Authority entitled "Report for the Commodity Futures Trading Commission: Trading in Leverage Contracts for Gold and Silver", and dated April 18, 1975. After the formation of the CFTC, an industry advisory committee was asked to conduct a further study of the leverage industry. See Advisory Committee on the Definition of Regulation of Market Instruments, 40 FR50557, October 20, 1975. The committee report entitled, "Report of the Commission's Advisory Committee on Market Instruments on Futures, Forward and Leverage Contracts and Transactions", was dated July 16, 1976. Next, an economic analysis was prepared by the Commission's Office of the Chief Economist. That analysis, concluding that leverage transactions were essentially contracts for future delivery, was discussed at the Commission's May 23, 1978 public meeting. The Futures Trading Act of 1978, Pub. L. no. 95-405, expanded Commission jurisdiction commodities other than gold and silver bullion. The Commission then requested its Enforcement Division to conduct a study of leverage transactions. See 43 FR56886, December 5, 1978. In September of 1978, the Commission's Office of General Counsel provided a legal memorandum to the Commission which was published for comment on March 12, 1979, 44 FR13494, recommending that the Commission determine to regulate leverage transactions as futures. In July of 1979, the Commission announced its intention to regulate leverage transactions as futures as of January 1, 1980, 44 FR44177, July 27, 1979. On November 20, 1979, the Commission determined to postpone the operative date of its decision on leverage transactions until June 1980. See 44 FR69304, December 3, 1979. On May 28, 1980, the Commission, citing a letter from its Congressional oversight committees, determined to postpone that determination once again until September 30, 1982. The Commission's legislative proposal postpones the decision yet again for two years.

38/ See transcript of CFTC public hearings on the application of the National Futures Association, June 4, 1981.

39/ See transcript of CFTC closed meetings on legislative recommendations in connection with reauthorization, January 26, 27, 28 and 29, 1982. There are only three firms currently active in the leverage business, according to the CFTC's Division of Trading and Markets.

40/ State regulatory jurisdiction during any study period, or permanently, could be effected simply by deletion of the reference to transactions subject to regulation by the Commission pursuant to Section 19 of the Act as it appears in the exclusive jurisdiction clause of Section 2(a)(1) of the Act and in the Commission's proposed language for Section 12(e).

41/ My letter concerning the CFTC's proposed options pilot program provides to the Senate Committee on Agriculture, Nutrition, and Forestry a more detailed comparison of the state of the art in securities and commodities regulation.

42/ See letter of comment to the Commodity Futures Trading Commission from Irving M. Pollack, Commissioner, Securities and Exchange Commissioner, February 19, 1980.

43/ See 46 Fed. Reg. 20679-20683, April 7, 1981. The CFTC has published proposed rules which would require all new applicants for registration as associated persons to pass a proficiency examination as a condition of registration. The Chicago Board of Trade has a rule (1605 RCR-examination) requiring that member firm sales personnel pass a National Commodity Futures Exam. Other exchanges have, from time to time, adopted similar rules. There remains no industry-wide requirement and no coverage of sales personnel in non-member firms. Because the National Futures Association's by-laws include provisions for the establishment of a testing program (See transcript of CFTC hearings, op. cit. 38), the CFTC has not adopted any final rules on testing.

44/ See R. Mundheim, Professional Responsibility of Broker-Dealers: The Suitability Doctrine, 1965 Duke L.J. 445 (1965) and N. Wolfson, R. Phillips & T. Russo, Regulation of Brokers, Dealers And Securities Markets, (1977), paragraph 2.08.

45/ See Report of the Commodity Futures Trading Commission Advisory Committee on Commodity Futures Trading Professionals, chaired by Commissioner Robert L. Martin, August 5, 1976.

46/ See 43 FR 31886, July 24, 1978. The Commission first rejected the proposed suitability rule at its public meeting of June 20, 1978.

47/ See staff document, prepared by the CFTC Division of Trading and Markets, concerning the Domestic Exchange-Traded Commodity Option Pilot Program, July 23, 1979, and transcript of CFTC public meeting on the options program, September 6, 1979.

48/ The Securities and Exchange Commission has 2150 employees according to its Office of Public Information. In contrast, the Commodity Futures Trading Commission presently has 471 employees (Source: CFTC Personnel Office).

49/ The Commodity Futures Trading Commission's Enforcement Division currently has 91 employees (Source: CFTC Personnel Office). The sales practice audit staff has four employees.

50/ See Testimony of Robert K. Wilmouth, President of the Chicago Board of Trade, and David Johnston, Chairman of Comex, at the CFTC public hearings on National Futures Association, Op. Cit. 38.

51/ See "NFA Board Opposes CFTC Recommendation for User Fees", Commodity News Services, February 1, 1982, in which an official of NFA is quoted as saying that consideration of user fees on commodity transactions renders prospects for the NFA in "grave doubt".

52/ This might be accomplished by supplementing the newly proposed amendments to Section 2(a)(1) of the Act in order to require that the Commission promulgate rules which assure that the customers in derivative securities instruments are afforded regulatory protection at least comparable to that provided in the primary markets under the securities acts and regulations.

53/ Customer abuse of the varieties described here would be violative of Commission Regulation 155.2, Trading Standards for Floor Brokers' (42 FR35009, July 7, 1977) and an array of exchange rules. The problem is that present trading and recordkeeping systems make detection and prosecution extraordinarily difficult. For additional discussion on the need for an audit trail, See "Regulation of the Commodity Futures Markets", a Report by the Comptroller General, General Accounting Office, May 1978, Pages 58-59.

54/ See SEC Rule 11a-1, 17 CFR §240.11a-1 (1975). The securities options markets curtail these activities by prohibiting a single broker from trading the same instrument for both his own and any customer's account during the same trading session. See, for example, American Stock Exchange Rules 111 and 950.

55/ A study performed for the Chicago Mercantile Exchange and submitted to the Commission in 1976 emphasized the prevalence of dual trading on commodity exchanges. For example, the report stated that approximately one-half of the volume in the lumber and live cattle markets was attributable to dual traders.

56/ Collection and recording of data is subject to a wide range of varying technologies at different commodity exchanges. In general, the older and busier the exchange, the more manual is the orientation of its trade and recording technology.

57/ Section 4j of the Act provides that "(t)he Commission shall within nine months after the effective date of the Commodity Futures Trading Commission Act of 1974, and subsequently when it determines that changes are required, make a determination, after notice and opportunity for hearing whether or not a floor broker may trade for his own account or any account in which such broker has trading discretion, and also execute a customer's order for future delivery and, if the Commission determines that such trades and such executions shall be permitted, the Commission shall determine the terms, conditions and circumstances under which which trades and such executions shall be conducted: Provided that any such determination, at a minimum, shall take into account the effect upon liquidity of trading of each market. . ."

58/ A staff memorandum prepared by the CFTC Division of Enforcement describes the difficulty in the following terms: "Without a transaction reporting system which provides adequate market reconstruction capability, it will be virtually impossible for the exchanges to design trading surveillance systems to detect the forms of manipulative activities

58/ Continued

(especially reporting of non-existent transactions) which were encountered in the securities options markets. Moreover, any such violative conduct which may be detected will be very difficult to prove absent an audit trail." Staff Document, June, 1981.

59/ CFTC Rule 1.35(g), 41 FR46134, December 23, 1976, required implementation of one-minute time-stamping effective June 13, 1977.

60/ Ibid. (41 FR46134). See, also, Final Report of the Commission "Bracketing" Task Force, July 14, 1976, (public document, Commission files).

61/ See June 9, 1977 letter from New York Cocoa Exchange concerning Rule 1.35(g). Compare May 25, 1977 Petition of Chicago Board of Trade for relief from provisions of Rule 1.35(g), (public document, Commission files).

62/ On November 26, 1980, the Commission adopted Rule 1.35a-(T) which eliminates one-minute time-stamping as a Commission requirement of and substitutes 30-minute bracketing. 45 FR79753, December 2, 1980.

63/ The number of reparations cases pending before the CFTC's Hearings Section rose from 343 at the end of fiscal year 1978 to 700 in 1979, 1172 in 1980 and 1389 in 1981. (Source: CFTC Office of the Executive Director).

64/ The CFTC's legislative proposals includes several amendments to Section 14 of the Act. The effect of these amendments would be to permit the Commission substantial discretion in determining the rights of parties and procedures applicable under the reparations program.

65/ Clayton Brokerage Co. of St. Louis, Inc. v. Leist, Smith and Incomco No. 80-895; New York Mercantile Exchange, Levie, Gabler, and Pennisi v. Leist, Smith and Incomco, No. 80-775; Heinhold Commodities, Inc., Thomson & McKinnon Auchinloss Kohlmeyer, Inc. v. Leist, Smith and Incomco, No. 80-936; Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Curran, No. 80-203.

66/ CFTC meetings on reauthorization, Op. Cit. 39.

67/ Ibid.

68/ The Commission has not offered any legislative recommendations specifically directed toward the subject of conflicts of interest. It is apparently the view of the Commission and the staff that no practical and comprehensive solution to this problem is available consistent with a continued emphasis on exchange self-regulation. None, at least, has been suggested.

69/ CFTC meetings on reauthorization, Op. Cit. 39.

70/ In Smith v. Groover, Civil Action No. 77C 2297 (N.D., Illinois), the CFTC filed a memorandum amicus curiae in which it stated: "Even if the Commission did have the resources to bring its enforcement powers to bear upon all apparent violations of the Act -- which it does not -- those powers provide no mechanism for compensating persons who may have been inured . . .", at 25, and "To the extent exposure to liability might inhibit exchange self-regulatory efforts, however, we believe that this possibility can generally be ameliorated by the imposition of a standard of culpability which balances the interests. . .", at 27.

The CFTC's legislative proposal may be contrasted with its current stance as amicus curiae in a case before the Supreme Court, Clayton Brokerage Co. of St. Louis, Inc. v. Leist, Smith and Incomco, No. 80-895; New York Mercantile Exchange, Levie, Gabler, and Pennisi v. Leist, Smith and Incomco, No. 80-775; in which its memorandum states: "Because establishing that manipulation has occurred or that an exchange has breached its self-regulatory duties often requires costly and complex litigation, private rights of action in this context are a particularly important supplement to the Commission's enforcement effort. Moreover a possibility of private suits provides a meaningful incentive for commodity exchanges to exercise an appropriate degree of vigilance in performing their self-regulatory duties." at 2.

To grant exchanges and their officials a complete exemption from private damage suits would, of course, provide a protection beyond that available to public officials under prevailing law. Compare Butz v. Economou, 438 U.S. 478 (1978), at 507.

71/ Ibid., Smith v. Groover.

72/ CFTC meetings on reauthorization, Op. Cit. 39.

73/ The Commission designated the Chicago Mercantile Exchange a contract market in Three Month Eurodollar Time Deposit Rates (settled in cash based upon the London Interbank Interest Rate) on December 8, 1981.

74/ CFTC meetings on reauthorization, Op. Cit. 39.

75/ The Chicago Board of Trade has eleven stock index contracts pending for Commission approval including an Industry Composite Portfolio; an Air Transport Portfolio, an Automotive Portfolio, a Banking Portfolio; a Chemical Portfolio; a Drug Portfolio; an Information Processing Portfolio; a Petroleum Portfolio; a Photo-Optic Portfolio; a Retail Portfolio; and a Telecommunication Portfolio.
The New York Futures Exchange has stock index contracts pending on the New York Stock Exchange Composite Index; the NYSE Financial Index; the NYSE Transportation Index; and the NYSE Utility Index. The Chicago Mercantile Exchange has a proposed contract pending designation

75/ Continued

on the Standard & Poor's Composite Index. The Commodity Exchange Inc., has pending a contract based on a 500 stock composite index. The Chicago Board of Trade has submitted to the CFTC a futures contract based on the prime rate charged by major domestic banks.

76/ Personal savings, one of the principal sources of real investment capital, averaged 6.8 percent of disposable personal income in the U.S. during the 1950's, fell to 6.6 percent in the 1960's, to 5.7 percent during 1976-79, and then to 5.3 percent during 1981. In contrast, the personal savings rate during 1980 was 14.5 percent in West Gemany and 14.3 percent in France. During 1979, it was 18.3 percent in Japan. (Source: Bureau of Economic Analysis, U.S. Department of Commerce).

Gross fixed capital formation as a percentage of GNP during 1980 was 17.8 percent in the U.S., 21.6 percent in France, 23.4 percent in West Germany and 31.8 percent in Japan, according to the U.S. Department of Commerce, International Trade Administration's International Economic Indicators, December, 1981.

77/ On February 7, 1929, the Federal Reserve Board of Governors issued a statement warning of the "excessive amount of the country's credit absorbed in speculative loans" and asked member banks to refuse additional loans for market speculation. The Day The Bubble Burst, G. Thomas and Max Morgan-Witts, Doubleday & Co., 1979, page 61.

78/ See The Commission's 1981 Report to Congress In Response to Section 21 of The Commodity Exchange Act, Pub. Law 96-276, 96th Congress, 2d Sess., Section 7, 94 Stat. 542, pages 49-50.

79/ This issue creates some strange intellectual alliances. George Gilder, a leading neo-conservative, has written that (as the 1980's began). . . "The upper classes, normally the cutting edge of the economy -- the source of most investment -- fled to unproductive tax shelters and hoards of gold, real estate, and speculation." He continues: "The economy is reoriented away from productive enterprise and toward Caribbean resorts and early retirements. The land, the precious metals, the works of art just sit there, growing more valuable for a while, but for the most part contributing little to the welfare of the people or the productive capital of the economy" and observes that "Speculation abounds in existing commodities, in land and gold and art, or in gambling stocks, while the durable capital of the nation -- necessary for all its further wealth -- wastes away." G. Gilder, Wealth and Poverty, Basic Books, 1981. Pages 20, 42 and 189.

80/ See Smith, Adam, The Wealth of Nations, Dutton, New York (1936) page 24; Mill, John Stuart, Principles of Political Economy, August M. Kelley, Fairfield (1976) pages 525-8; Marshall, Alfred, Principles of Economics, page 26.

81/ Various members of Congress have, from time to time, expressed concern over the lack of knowledge on this subject. See letter to CFTC from Congressman Benjamin S. Rosenthal, Chairman, Subcommittee on Commerce, Consumer and Monetary Affairs, House Committee on Government Operations, February 10, 1982 and letter to CFTC from Congressman John D. Dingell, Chairman, House Committee on Energy and Commerce, February 5, 1981. In "Additional Views" attached to the House Report on the legislation reauthorizing the CFTC in 1978, Congressman Dan Glickman noted: "no one, not the CFTC, not the SEC, not OMB and not GAO, has any substantive ideas on how much money has moved out of the equity markets and into the futures markets during the past several years. In fact, no one in a position to know seems to have the foggiest idea on how the development of futures on financial instruments, including securities will affect our capital markets and economy in general." Glickman went on to say that "given the potential for significant impact on our economy and the rapidly changing nature of the futures industry," such data should be compiled and evaluated.

82/ The public interest test is set forth in Section 5(g) of the Act. The Act authorizes and directs the Commission to designate a contract market in a particular commodity future, when and only when, among specified other things, the "board of trade demonstrates that transactions for future delivery in the commodity for which designation as a contract market is sought will not be contrary to the public interest."

83/ In explaining the statutory language concerning the public interest, Mr. Talmadge, then Chairman of the Senate Committee on Agriculture, Nutrition and Forestry, stated: "The committee intends by its language to broaden the scope of the test which the Commission must apply before designation of a particular contract market . . . . Clearly, if a market were being used almost entirely for speculation rather than for legitimate hedging, it would not be in the public interest." (September 9, 1974, Cong. Record, Senate 30467-8). The Conference Report on the Act states, p. 36: "The Conferees note that the broader language of the Senate provision would include the concept of the "economic purpose" test provided in the House bill subject to the final test of the "public interest". The House bill had set forth a more specific hedging or price-basing standard. S. Rep. No. 1194, 93rd Cong., 2d Sess. 36 (1974) (Report of the Committee of Conference).

84/ On May 13, 1975 the Commission published its Guideline 1, which sets forth the standards proposed contracts must be met in order to be designated. Guideline on Economic and Public Interest Requirements for Contract Market Designation, Commodity Futures Law Reporter (CCH), Paragraph 6145. Also, See Report of the Comptroller General (1978). Op. Cit. 53.

85/ Section 2(a)(8) of the Act requires CFTC solicitation of comments from the U.S. Treasury Department and the Federal Reserve Board on pending futures contracts involving securities issued or guaranteed by the U.S. government. The Commission's proposed legislative package would amend Section 2(a)(1) of the CEA to require that upon application by a board of trade for designation as a contract market in a stock index futures contract, or option on such a contract, the Commission shall provide an opportunity for public comment on such contracts and consult with the Securities and Exchange Commission with respect to such designation.

86/ In 1978, Section 4c(c) of the Act was added prohibiting, with certain exceptions, any option transaction involving any commodity regulated under the Act until "the Commission transmits to the House Committee on Agriculture and the Senate Committee on Agriculture, Nutrition and Forestry, documentation of its ability to regulate successfully such transactions. . ."

87/ 46 F.R. 54500, November 3, 1981.

88/ *See* transcript of CFTC open meeting concerning designation of the Kansas City Board of Trade as a contract market in the Value Line Average of common stock, February 16, 1982.

89/ The general point is well established in classical literature, but the impact on markets of uninformed or oversized traders is not well studied in the modern academic literature of financial markets.

90/ The CFTC Division of Economics and Education has compiled statistics which indicate percentages of long and short speculative participation in the following contracts for fiscal 1979.

Commodity	Market	Long	Short
Gold	IMM	92.5	87.7
	Comex	81.3	73.1
Silver	CBT	95.9	91.0
	Comex	85.6	76.0
U.S. T-bills (90-Day)	IMM	83.9	77.5
Frozen Pork Bellies	CME	94.2	84.9

(Source: Staff document prepared in connection with the designation of the Kansas City Board of Trade as a contract market in the Value Line Average, February, 1982).

91/ Such a study might be most valuable if extended to all financial markets. The Treasury and Federal Reserve conducted a study of futures markets in 1979 but did not reach the macroeconomic issues. *Treasury Futures Markets: A Study by the Staffs of the U.S. Treasury and the Federal Reserve System, May 31, 1979*. In addition, pursuant to Section 21 of the Commodity Exchange Act, Op. Cit. 78, the Commission was directed to establish a joint working group with the Federal Reserve Board, Treasury, and the SEC to analyze and prepare a report on the events in the silver market during the period of September 1979 through March 1980. The study was expanded to include an analysis of financial futures markets as well. The study was thorough and valuable, but here, too, the macroeconomic effects were not directly addressed.

92/ *See*, "Journal of Futures Markets", Volume 1 Supplement, pp. 461-486, for summaries of a number of these proposals.